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Consumer financial advice and guidance for high risk DC savers

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Consumer financial advice and guidance for high risk DC savers

Executive summary

There has been an increased focus on the role of regulated financial advice, alongside the introduction of free guidance for individuals, in the light of the new pension flexibilities. Despite this, uptake of both guidance and advice remains relatively low and there are concerns, in particular, around those individuals who will rely on their Defined Contribution (DC) pension savings to supplement their state pension, who have low levels of financial education and are unlikely to take regulated financial advice.

Such concerns centre on the risks to the quality of life of these individuals if they prematurely exhaust their pension savings. However, there are also consequences for the economy of the UK if these groups rely on means-tested benefits having spent their pension savings. There are also potential macro-economic consequences where retired individuals have lower incomes through sub-optimal use of their retirement funds. With consumption typically declining with age, it has been noted that low levels of spending by older people could limit economic output, potentially worsening the UK's economic position.[1] Therefore, effective management of retirement savings could be beneficial in the following ways:

- Optimal management of their retirement funds may lead them to having higher incomes in retirement,
- This may also help them to avoid the negative consequences of prematurely exhausting their pension savings.

While it may not be the case for all individuals that an increase in their retirement income leads to increased spending, there is a risk that levels of consumption will decrease for those individuals who spend down their retirement savings prematurely.

In order to consider some of these concerns, LV= commissioned the PPI to research and provide an overview of demand for and the supply of financial advice and guidance, along with some of the options that might bring these in line with each other. This research provides an overview of some of the options with the aim of stimulating discussion around these, rather than providing any quantitative analysis of the likely outcomes of each option. Further investigation would be required to evaluate each option in order to assess the potential outcomes from these.

Regulation shapes the current landscape for supply of UK financial advice

The Retail Distribution Review (RDR), conducted by the re-named Financial Conduct Authority (FCA), introduced at the beginning of 2013, made far-reaching changes to the delivery of financial advice. It may have contributed to the decrease in the number of Independent Financial Advisers (IFAs) and their increased focus, due to commercial considerations, on wealthy individuals. This increasing focus on wealthier individuals occurred at the same time as the appearance of a new group of individuals with relatively modest pots who may

[1] Brancati, et al (2015)

benefit from financial advice around retirement as a consequence of the pension flexibilities. This represents a potential lack of fit between the supply of and demand for financial advice.

A range of guidance and advice services is currently available to UK Defined Contribution (DC) savers

While individuals may choose to access regulated financial advice, a range of free guidance services is also available to individuals. As well as advice from employers, pension providers and government departments, this includes Pension Wise, a potentially valuable government-funded service that was introduced as a result of the introduction of the pension flexibilities from April 2015.

There remains a gap in advice and guidance provision

As the Pension Wise service does not advise individuals on how to use their pension funds, individuals who use the service may still face complex decisions, although they may be better informed about available options. While the Pension Wise service is highly regarded and therefore potentially very valuable the volume of customers is low relative to the population approaching retirement with DC savings. Of those who have withdrawn some money from their DC pensions since April 2015, just over one in five have used Pension Wise.[2] Similarly, take-up of paid-for financial advice remains relatively low.

With the introduction of the new pension flexibilities, decisions about accessing DC pensions have become more complex

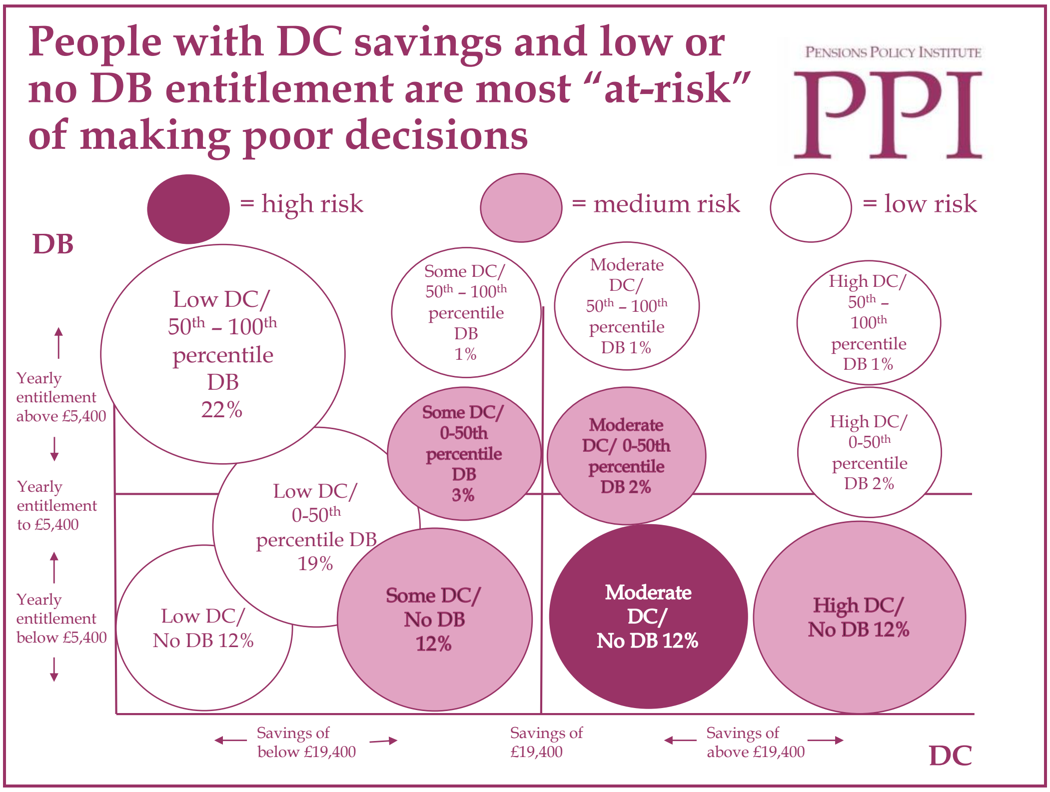
In light of this complexity previous PPI research has identified the characteristics of those who are most at risk of making sub-optimal decisions and may need advice or guidance most. This group of high risk individuals may be largely impacted by the financial decisions they make (Box Ex1 and Chart Ex1).

Box Ex1: High risk group[3]

The high risk group includes people with DC savings of £19,400 to £51,300 and no Defined Benefit (DB) entitlement. This constitutes 694,000 people, 12% of people who are aged 50-SPA (State Pension Age) in 2014. This group are at high risk of making sub-optimal decisions at retirement and may therefore benefit from financial advice.

[2] www.bbc.co.uk/news/business-35419330
[3] PPI (2014)

Chart Ex1



The high risk group faces barriers to seeking advice related to awareness, affordability and lack of trust in financial services

Some factors that prevent individuals from accessing advice or guidance include:

- Lack of awareness that advice exists
- Inability to afford advice or unwillingness to pay for advice at its current cost, including a perception of the cost of advice as a loss
- Lack of trust in financial services
- Lack of understanding of the benefits of financial advice
- Feelings of powerlessness or helplessness around issues related to finances
- Absence of an event that might trigger individuals to seek financial advice
- 'Egotistic discounting', overconfidence in one's own decisions

There remains confusion around what constitutes 'advice' and recognition that this may hinder the development of approaches that help individuals to implement the pension flexibilities

Different organisations have been more conservative in interpreting and applying these rules than others. The FCA has looked to clarify this; in particular it has pointed out that, where a decision tree is used, the person asking the questions would need to make any judgment or assessment that results in products being identified as suitable for the customer in order for this to be considered as regulated advice.

While many people are turning to technology to seek financial advice and guidance, there remains a group that online solutions to financial advice fail to reach, who may require other solutions

These people who are offline are more likely to be vulnerable groups such as older and/or disabled people and those from lower socioeconomic backgrounds.[4] The main digital divide lies between those below SPA (79% of households have access to the internet) and those above SPA (37%).

However, there is the potential for online solutions to reach the high risk group as internet access has consistently improved year on year (55% in 2005 to 86% in 2015). It is likely that in the future more people, including those above SPA, will have access to the internet, although there will be some exceptions to this.

Approaches that could address demand for financial guidance and advice include increasing awareness of Pension Wise and the introduction of greater numbers of employer-sponsored financial education programmes

More targeted publicity for Pension Wise may increase awareness of guidance and advice. An increase in the number of employer-sponsored financial education programmes would help consumers to assess the value of financial advice. These could also potentially address issues around trust in financial services and feeling of powerlessness, both barriers to seeking financial advice.

On the supply side, the use of scalable solutions, such as robo-advice and online guidance, is emerging in the UK and may reduce the cost of advice so that it is perceived as affordable

Under the new pension flexibilities, there is a group of individuals, with relatively small pension pots, who may benefit from financial advice at retirement but may not be prepared to pay for it. Scalable solutions with lower fees may be cheaper for these consumers and, with larger numbers using these solutions, may provide a commercial proposition to providers. Compared to the free guidance services, these have the benefit of offering a product recommendation.

Currently, the use of robo-advice and online guidance has focused on helping individuals manage their investments during their lifetime and prepare for retirement. However, approaches are emerging that help individuals to make decisions around how to access their retirement savings. This type of robo-advice and guidance is important because it targets groups of individuals who have not traditionally sought financial advice. However, the use of fully-automated advice may still be subject to the behavioural barriers that cause a reluctance to seek or take advice in the first place. Levels of take-up of these services, as well as outcomes from the use of robo-advice, remain to be seen.

However, any robo-advice solution will need to be sufficiently robust to deal with current market concerns around the risk of mis-advising people, as well as the potential for scamming.

[4] ONS (2015) Internet access

The cost of some types of advice to the individual may be reduced so that it is perceived as affordable by the introduction of a voucher scheme

Her Majesty's Treasury (HMT) recently issued a consultation around public financial guidance that made reference to a possible model of government-backed voucher scheme 'whereby a consumer could be provided with one or multiple vouchers for financial guidance or advice sessions which could be redeemed with a range of accredited partners.'[5]

Potential advantages of a voucher scheme include:

- raising awareness of financial advice
- normalising financial advice
- providing individuals with the right contacts if they require financial advice in excess of the voucher value

There may also be potential consequences for the economy if the provision of vouchers leads to individuals taking advice that enables optimisation of their retirement funds and, in turn, higher long-term income and expenditure and lower levels of reliance on means-tested benefits. Further modelling would be required to investigate this.

However, risks around voucher schemes include increases in fraud, customers incurring unexpected costs (where the value of the advice exceeds the voucher value) and the provision of low quality advice.

The use of default strategies could be an alternate or complementary approach

An alternate or complementary approach would be to increase the use of default strategies in retirement that might be used with or without financial advice. Defaults have been used in the UK during the accumulation phase where automatic enrolment harnesses individuals' inertia with the aim of increasing pension contributions. The effectiveness of defaults depends on whether there is sufficient common ground between groups of DC savers approaching retirement to inform the proactive design of new default strategies, or a limited set of choices, that can support them into retirement even if they fail to engage.

These approaches to advice or guidance are unlikely to provide certainty around outcomes

This lack of certainty contrasts with the period preceding the new pension flexibilities in which annuities provided some level of certainty at a cost to the individual. Regardless of whether individuals use guidance, advice or defaults, a challenge remains around how to communicate this type of uncertainty in a way that enables individuals to make informed choices about their retirement savings

[5] www.gov.uk/government/consultations/consultation-public-financial-guidance

Introduction

The growth in Defined Contribution (DC) pensions alongside the introduction of new pension flexibilities has introduced an additional layer of complexity around the use of retirement savings. While the flexibilities have provided individuals with a greater number of options, they have also placed more responsibilities on them and introduced greater risks to both the individual and the State.

In light of these developments there has been an increased focus on the role of regulated financial advice, alongside the introduction of free guidance for individuals. Despite the provision of services such as Pension Wise, a highly regarded and therefore potentially valuable service, uptake of both guidance and advice remains relatively low. As a result there are concerns, in particular, around those individuals who will rely on their DC pension savings to supplement their state pension, who have low levels of financial education and are unlikely to take financial advice.

Such concerns centre on the risks to the quality of life of these individuals if they prematurely exhaust their pension savings. However, there are also consequences for the UK economy if these groups rely on means-tested benefits having spent down their pension savings. There are also potentially macro-economic consequences where retired individuals have lower incomes through sub-optimal use of their retirement funds. With consumption typically declining with age, it has been noted that lack of consumption by older people could limit economic output, potentially worsening the UK's economic position.[6] Therefore, effective management of retirement savings could be beneficial, potentially leading DC savers to have higher incomes in retirement. This may also help them to avoid the negative consequences of prematurely exhausting their pension savings.

There is a need for financial advice and guidance to reach individuals who are most at risk of making sub-optimal decisions around their pension savings. Her Majesty's Treasury (HMT) have recognised this advice gap and is currently conducting the Financial Advice Market Review (FAMR) with a view to introducing a package of reforms that facilitates the development of a broad-based market for financial advice that will meet the needs of all consumers.

This report *'Consumer financial advice and guidance for high risk DC savers'* aims to contribute to evidence and the debate on these issues.

The first chapter of this report considers demand for financial advice and guidance, and the second chapter provides an overview of the supply of these services. The third chapter considers the different approaches that might be available to help individuals in these circumstances, drawing on the existing marketplace and recent developments.

[6] Brancati, et al (2015)

Chapter one: demand for consumer financial advice and guidance in the DC market

This chapter looks at the demand for financial advice. There is a particularly high risk group of people who are approaching retirement and are predominantly reliant on their Defined Contribution (DC) savings. This group face complex and high-impact decisions about their pensions. This chapter sets out the possible reasons for the advice gap, which may stem from structural, personal or behavioural factors.

Financial advice involves offering a recommendation on a specific transaction or product to an individual, and is regulated by the Financial Conduct Authority (FCA). Financial advice can be independent or restricted. Guidance differs from advice, in that it does not provide a recommendation on product choices. Guidance is also referred to as information-only or non-advice services.

There are potential macro-economic consequences where retired individuals do not receive appropriate guidance or advice and, as a result, risk having lower incomes through sub-optimal use of their retirement funds. With consumption typically declining with age, it has been noted that low levels of spending by older people could limit economic output, potentially worsening the UK's economic position.[7]

Recent research suggests people seek financial advice based on the level of complexity and the level of impact on their wealth. The analysis of advice seeking in members of a DC pension fund in Australia highlighted that gender, age, value of the pension pot and experience with financial products may also be influencing factors on how people seek and take advice. The research suggested that women are more likely than men to seek advice and tend to trust advisers that they can see and hear rather than contact through an online platform.[8]

With the introduction of the new pension flexibilities decisions about accessing DC pensions have become more complex

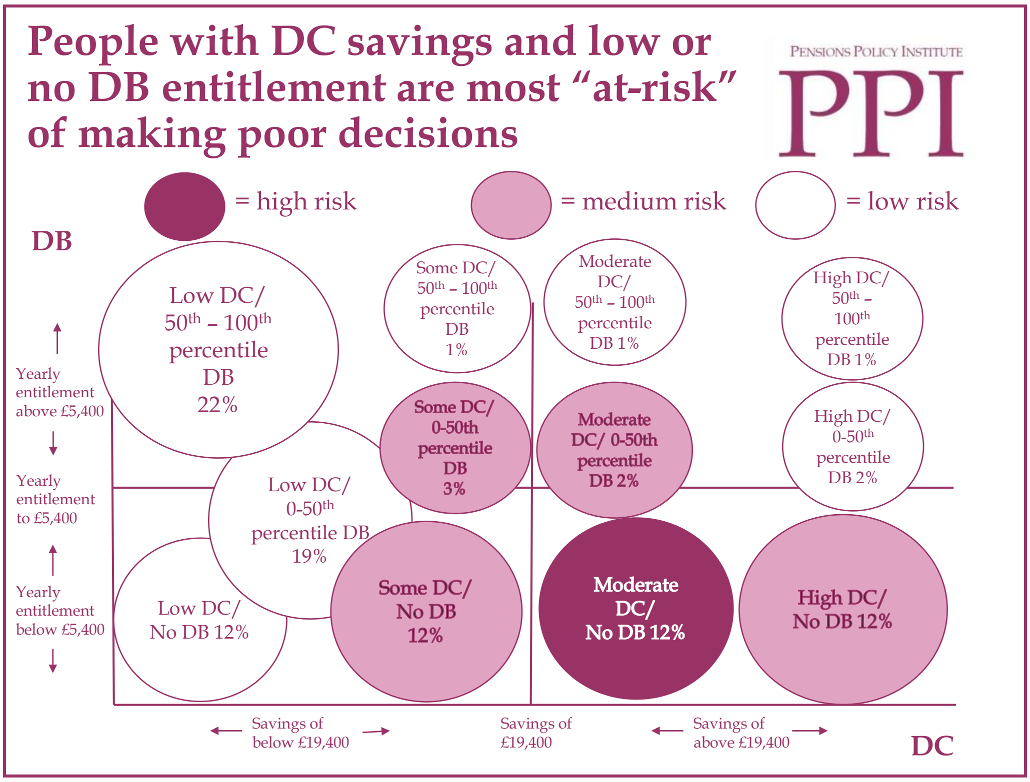
Previous PPI research has identified the characteristics of those who are most at risk of making sub-optimal decisions and where advice is needed most.[9] The research found that decisions about accessing DC pensions are considered to be the most complex and challenging of all major financial decisions that are made across the life course. The research identified a group of high risk individuals who may be largely impacted by the financial decisions they make (Box 1).

[7] Brancati, et al (2015)
[8] Clark et al, (2015), The demand for advice in a defined contribution plan
[9] PPI (2015)

Box 1: High risk group[10]

The high risk group includes people with DC savings with DC savings of £19,400 to £51,300 with no DB entitlement. This constitutes 694,000 people, 12% of people who are aged 50-SPA in 2014. This group are at high risk of making sub-optimal decisions and may therefore benefit from financial advice.

Chart 1



The high risk group in Chart 1 are likely to rely mainly on their state pension or state benefits, have limited or no Defined Benefit (DB) entitlement and have moderate DC savings which could be used to support them through retirement through a range of ways such as:

- A source of retirement income;
- Spending on necessary items (home repairs);
- Clearing debts.

However, this group scores low on financial proxy indicators. This means that they are more likely to have lower levels of financial skill and knowledge than people in other groups. The high risk group are less likely to take independent advice which could aid them through the decision making process.

[10] PPI (2014)

The high risk group can face a range of structural and behavioural barriers preventing them from seeking advice

These barriers indicate where the demand lies and what groups of people are likely to face them.[11] The advice gaps are not necessarily directly related to the discrepancy between the cost of financial advice and what people are willing to pay, but can relate to structural barriers such as the targeting of wealthier customers by the financial advice market.

There could be further behavioural factors that affect individuals when it comes to advice

Other factors may lead to behaviours in advice-seeking and advice-taking which are less than rational, i.e. a reluctance to seek or take advice even where there is a clear benefit to the individual. These factors could be conceived as a different 'advice gap', although they may also play into the structural advice gaps suggested by Citizens Advice, listed in Table 1.

Table 1. Structural Barriers to attaining advice[12]

Awareness	There is a lack of awareness about advice creating a structural barrier. This includes those who: • Are not aware that advice exists or where/who to turn to (estimated 10m); • Need free guidance and did not have it, or those who would benefit but have not received it, due to not knowing it exists (estimated 14.5m).
Affordability	There are two groups of consumers who face affordability barriers when attaining advice: • Those who are unable to afford advice; • Those who are willing and able to pay for advice, but not at current market cost (Citizens Advice estimated 5.4m people in the UK). Only 6% of people would pay £500 or more for simple investment advice.[13] This links into further behavioural factors such as when people perceive the cost of advice as a loss, even if they would benefit from it in the future.

Recent research in behavioural economics has suggested a number of factors that impact the decision-making processes. In 2009, the Cabinet Office produced the MINDSPACE[14] report, which offers a checklist of "the most robust non-coercive influences on our behaviour". There are a number of these influences that could affect advice seeking and advice taking that goes further than market-based explanations of the advice gap. Some of these behavioural barriers are explained in Table 2.

[11] Citizens Advice, (2015), The four advice gaps
[12] Citizens Advice, (2015), The four advice gaps
[13] Unbiased.co.uk
[14] Institute for Government, (2012), MINDSPACE Behavioural Economics

Table 2. Behavioural barriers in attaining advice

Trust	People judge the importance of advice based on where and who it comes from. A lack of trust in an advisor could be a barrier to seeking advice. There is a lack of trust in the UK financial services market, including pensions.[15] There is a tendency to accept advice from those close to you, such as friends or family, even if they are not qualified or expert. The pension landscape is complex, and there is a danger that following advice from a friend or family member regarding what worked for them may not make sense for an individual. This particularly applies to the high risk group identified, who face very complex decisions.
Expected benefit	Studies of access to advice in legal services show that the likelihood of seeking advice is influenced by the nature of the problem as well as the expected benefit. If the expected benefit is misunderstood or underestimated, this could discourage individuals from seeking advice. The legal services study also found that the most common reason for doing nothing in regard to a legal problem was a feeling of powerlessness or helplessness towards the issue.[16] This coincides with the FAMR review, which has recognised that there is also an advice gap where demand is low, because long-term benefits of advice may not be fully appreciated.
Mental accounting	Mental accounting describes how people compartmentalise their money for different purposes. For people with limited funds who are trying to save as much as they can for their pensions, there may not be space in any "pot" to pay for advice in the short-term. This is also related to barriers around affordability where people perceive the cost of advice as a loss, even if they would eventually make money from it – as they perceive it to be unaffordable.
Continuous vs. discrete	The authors of research into DC funds in Australia[17] described how people frame pension decisions as discrete rather than a continuous process, and this means that singular events can have a disproportionate effect on their decisions. Unless triggered by a major event, people are unlikely to seek advice to support their pension decisions.
Egoistic discounting	Individuals often make decisions regarding to what makes them feel better about themselves. This can play out as what has been called "egoistic discounting", or overconfidence in one's own decision.

[15] Lord Hutton (2015)
[16] Legal Services Research Centre (2004)
[17] Clark et al, (2015), The demand for advice in a defined contribution plan

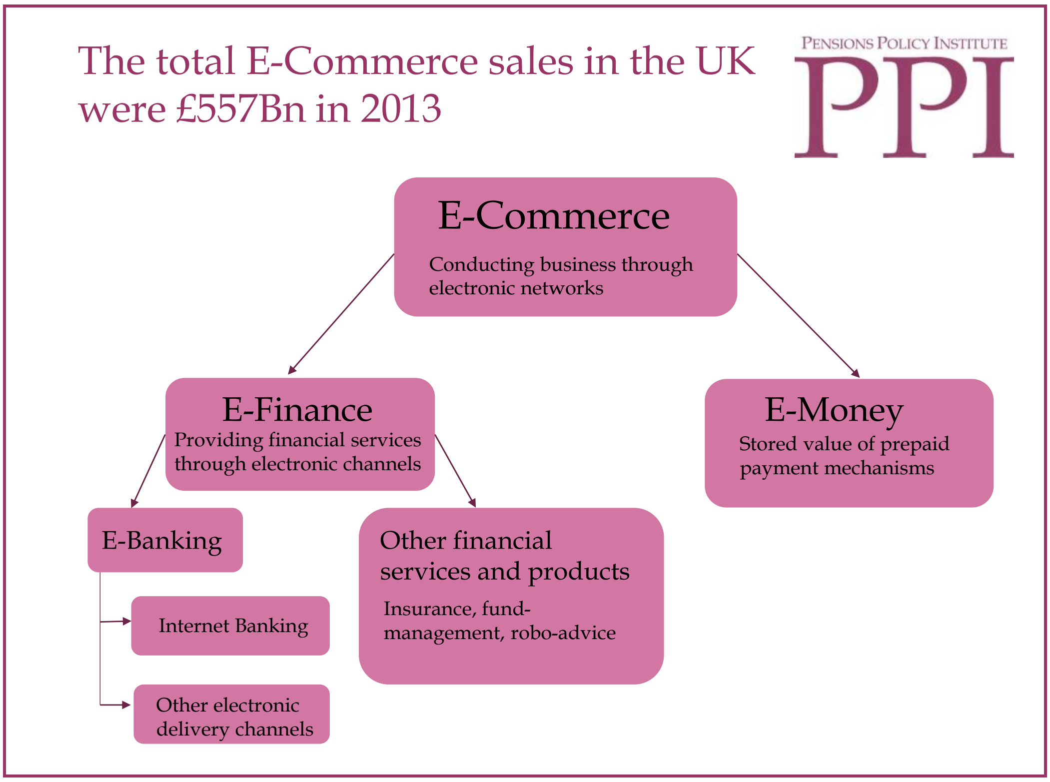
	The advice may take account what the individual already believed, even if they have no prior experience or expert knowledge in the area. It is possible that the decision maker's initial judgement acts as an anchor, which adjusts what the advisor subsequently tells them.

Many people are turning to technology to seek financial advice as a response to overcome structural or personal barriers such as cost or accessibility

There is an increasing dependency on the internet in today's society with 24/7 accessibility and interactive media being the norm for many.

With this in mind, more people are using technology than ever before for various reasons such as shopping, banking and attaining advice. In 2015, 86% of households in Great Britain had access to the internet,[18] opening up the opportunity for purchasing online services such as insurance, fund management and financial advice.[19] The e-finance sector covers a range of services, illustrated in Chart 2.

Chart 2



[18] ONS (2015) Internet access
[19] The age of responsibility, (2015)

The financial services industry is investing in research around technologically driven alternatives to financial advice and guidance for consumers who are caught in the advice gap

This type of advice is known as robo-advice and is an increasingly popular subject in the advice market. It works by using algorithms to help answer money based questions online.[20] This means companies can offer advice more quickly and cheaply, further targeting the high risk group that are reliant on their DC savings and those within this group who cannot afford a face-to-face appointment with an Independent Financial Adviser (IFA). IFA's provide tailored advice and recommendations that take into account individuals' circumstances.

There are many advantages of online solutions to financial advice such as its convenience and 24/7 accessibility, which makes it an attractive option. Specifically, the use of technology in advice can also help to simplify the messages through the advice process with online tools and multimedia presentations.[21] This could help to aid those with lower financial literacy. One of the main advantages of robo-advice is the likely cost, which could make it an attractive alternative option to an IFA. However, there is a group of people that online solutions to financial advice fail to reach, including the 7.63 million adults who have never used the internet.[22]

People who are offline are more likely to be vulnerable groups, such as older and/or disabled people and those from lower socioeconomic backgrounds. The main digital divide lies between those below State Pension Age (SPA) (79% of households have access to the internet) and those above SPA (37% of households having access). This means that household composition and age affect internet access, those above SPA could be excluded from attaining advice through an online platform. As internet access has increased (55% in 2005 to 86% in 2015) and a greater number of people over SPA will have internet access in the future, there is a potential for online solutions to reach some members of the high risk group.

Research conducted by the International Longevity Centre – UK (ILC-UK) found that best buy comparison websites most influenced decisions about which retirement product to take out on a whole. However, older (age 55+) consumers are significantly more likely to be influenced by IFAs or providers, than by best buy information on websites.[23]

The use of the internet in other financial contexts, such as the provision of online banking, can highlight some of the issues that arise from advice online. Using the internet has become an increasingly popular way of managing finances. Despite the 'digital divide', older people are contributing to the popularity of online banking with 6.5 million people over the age of 60 banking online.[24] There are many governance, regulatory and reputational risks that online banking poses. These risks also apply to the provision of and take-up of robo-advice.

[20] Financial Advice Network
[21] The age of responsibility, (2015)
[22] ONS (2015) Internet access
[23] ILC-UK, (2015), Financial Advice Market Review: A response from the International Longevity Centre -UK
[24] www.computerweekly.com/news/2240238887/UK-senior-citizens-boost-online-banking-popularity

Chapter two: supply of consumer financial advice and guidance in the DC market

This chapter considers the supply of financial advice and guidance, and focuses on the gap for the provision of such services, which affects those with modest Defined Contribution (DC) funds. It provides an overview of advice and guidance provision alongside consideration of the factors that have influenced the supply of these services to date, specifically the regulatory framework.

It goes on to outline some of the more recent developments, including the development of robo-advice and online guidance that has arisen as a result of, or alongside the pension flexibilities.

Broadly, where a personal recommendation is made as being suitable for an individual, this is considered to be advice. If this is not the case, the interaction would be considered to be guidance.

There remains confusion in the context of the new flexibilities around what constitutes 'advice' and recognition that this may hinder the development of approaches that help individuals to implement the pension flexibilities

Different organisations have been more conservative in interpreting and applying these rules than others. The Financial Conduct Authority (FCA) has noted confusion around what constitutes regulated advice and that this is particularly problematic in the context of the pension flexibilities. Under these flexibilities individuals may benefit from tools such as decision trees, which appear to fall between guidance and advice. The FCA has clarified the following:

- In order to be regulated, advice must relate to a specific investment and to a person in their capacity as an investor.
- Generic advice is not a regulated activity but when given with regulated advice it becomes part of the regulated advice.
- The term simplified advice refers to a limited form of advice, focussed on one or more specific consumer needs, and may involve a specific recommendation about products.

In order to ensure the quality of offerings, the same requirements for training and standards, including requirements around assessing the suitability of advice, apply to the provision of simplified advice as to full advice. However, there is some flexibility around this; e.g. the suitability test is qualified by reference to 'the nature and the extent of the service provided'.[25]

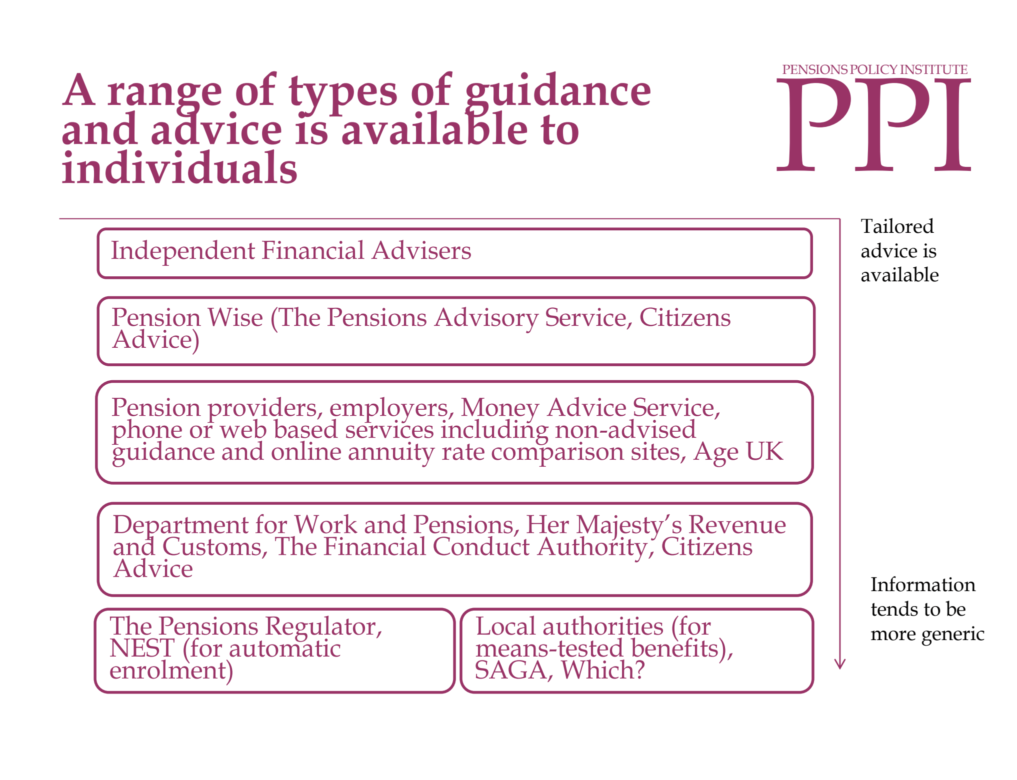
Where a decision tree is used, the person asking the questions would need to make any judgment or assessment that results in products being identified as suitable for the customer in order for this to be considered to be regulated advice.

[25] FCA (2015)

A range of guidance and advice services is available to UK DC savers

While individuals may choose to access regulated financial advice, explored later in this chapter, a range of free guidance services are also available to individuals (Chart 3). At one end of the range are Independent Financial Advisers (IFAs), who provide tailored advice and recommendations that take into account individuals' circumstances. At the other end of the range, resources are available that may address only one aspect of an individual's pension arrangements, such as tax, and rely on the individual to interpret the relevance of the information in light of their own circumstances.

Chart 3



Contrary to the names of the Pension Wise providers, The Pensions Advisory Service and Citizens Advice, these organisations provide free guidance rather than regulated advice. This is because they do not recommend products or advise individuals what to do with their money.

Pension Wise, a government-funded service, was introduced as a result of the introduction of the pension flexibilities from April 2015. This is open to everyone aged over 50 with a Defined Contribution (DC) pension and offers a 45 minute conversation with individuals in which a guidance specialist explains pension options, tax and discusses which options might be suitable. Box 2 shows figures for Pension Wise uptake and levels of satisfaction.

Box 2: Figures for Pension Wise, published on 17 December 2015[26]

Since the launch of Pension Wise in early 2015:
1.94m visits to the website
40,600 completed incidences of guidance
78% face-to-face appointments
22% telephone appointments

The customer satisfaction score from user feedback is currently 89%.

In terms of page views, the most popular topics are *'What you can do with your pension pot,'* with over 53,000 views.

Organisations such as government departments can provide guidance on specific areas such as tax (Her Majesty's Revenue and Customs) and the state pension (Department for Work and Pensions).

There remains a gap in advice and guidance provision

Pension Wise service provides information and guidance to individuals on how to use their pension funds. Individuals who use the service may still face complex decisions, although they may be better informed about available options. While the Pension Wise service is highly regarded and therefore potentially valuable, the volume of customers is low relative to the population approaching retirement with DC savings. Of those who have withdrawn some money from their DC pensions since April 2015, just over one in five have used Pension Wise.[27]

Similarly, take-up of paid-for regulated advice remains relatively low. There remain concerns, in particular, around the group identified as being at high risk of making sub-optimal decisions around accessing their pension savings.

Regulation shapes the current landscape for provision of financial advice in the UK

Regulations affects the provision of financial advice in terms of determining who is permitted to provide financial advice, how individuals and organisations charge for financial advice and the type of information that they provide to their customers. Costs incurred by advisers in complying with regulations also influence the supply of financial advice. The distribution of financial advice in the UK is formally regulated by the Financial Conduct Authority (FCA), and two elements of regulation, in particular, have influenced the supply of financial advice:

- The Retail Distribution Review (RDR)
- Regulations Activities Order (RAO)

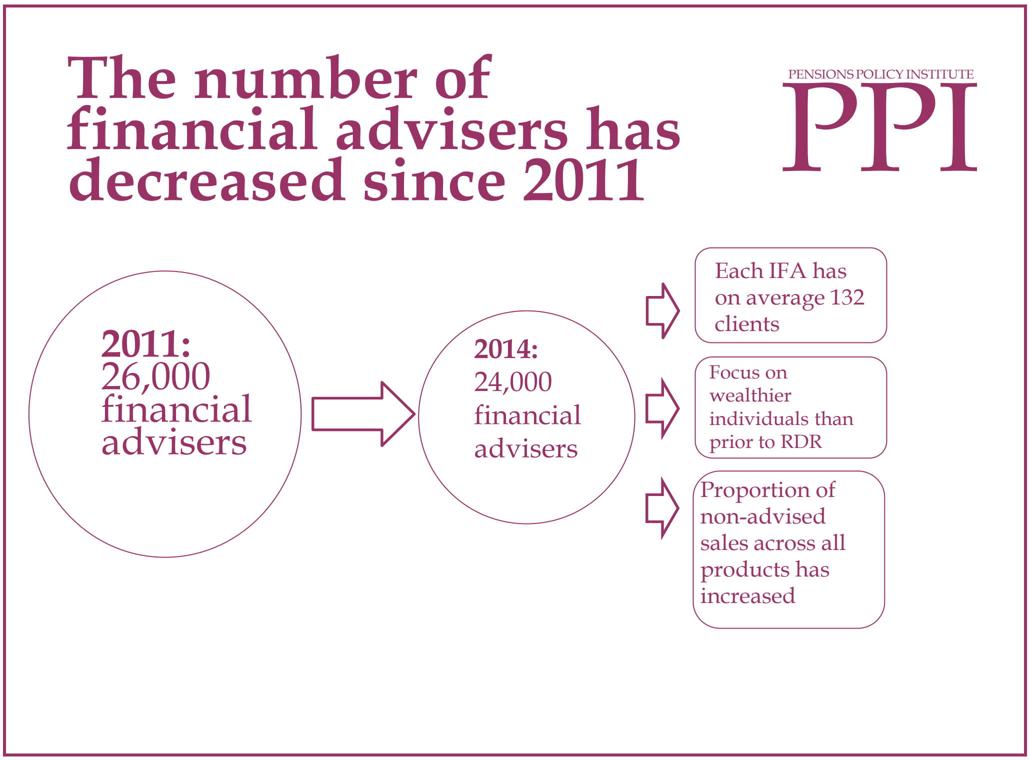
The RDR made far-reaching changes to the delivery of financial advice and may have contributed to the decrease in the number of IFAs and their increased focus on wealthy individuals (due to issues around commercial viability).

[26] www.gov.uk/performance/pension-wise
[27] www.bbc.co.uk/news/business-35419330

Broadly, from 2013 onwards, advisers are no longer able to take commission when recommending investment or pension products and are required to disclose their fees upfront.

There have been changes to the supply of financial advice that have been imputed to the RDR, in particular a decrease in the number of financial advisers[28] and an increased focus on wealthier individuals, such as high net worth individuals who own a number of investment products including pensions (Chart 4). It has been argued that this is due to increased costs and complexities that have led IFAs to focus on wealthier individuals in order to meet the increased cost of advice provision.[29]

Chart 4[30]



This increasing focus on wealthier individuals occurred at the same time as the appearance of a new group of individuals with relatively modest pots who, as a consequence of the pension flexibilities, may benefit from financial advice around retirement. This represents a potential lack of fit between the supply of and demand for financial advice.

Assessments of the cost of financial advice vary, with the average hourly rate estimated at £150.[31] However, the full cost of financial advice will vary by transaction, e.g. the financial adviser website unbiased.co.uk estimated the cost of converting a £30,000 pension fund into a lump sum and annuity as £825.[32] The

[28] FCA (2015)
[29] Citizens Advice (2015)
[30] APFA (2015)
[31] www.moneyadviceservice.org.uk/en/articles/guide-to-financial-adviser-fees
[32] www.unbiased.co.uk/cost-of-financial-advice-guide

cost of simplified advice, a limited type of advice focused on one or more specific needs, has been estimated as costing between £150 and £250.[33]

Currently, employers can provide £150 of pension advice per year tax-free to employees. However, if an employer provides advice to the value of more than £150, the whole amount is considered to be a 'benefit-in-kind' and the tax-free element is lost.

The proportion of non-advised sales is growing. In 2006/7 32% of sales were non-advised, increasing to 67% of sales being non-advised in 2013/14 (across all product sales and types of financial advisers).[34]

Provision of advice is a regulated activity as identified by the Regulated Activities Order (RAO)

The RAO identifies the type of activity that must be regulated, including the distribution of financial advice, which is currently regulated by the Financial Conduct Authority (FCA), previously the Financial Services Authority (FSA). The FCA aims to protect consumers and the integrity of the financial system, as well as promoting competition within the market. The FCA regulates what constitutes advice and how it is delivered to the consumer. Financial advisers have to conduct particular activities in order to comply with FCA regulations (Chart 5).

Chart 5

Regulatory requirements for IFAs

PENSIONS POLICY INSTITUTE PPI

Authorisation

- IFAs must be registered with the FCA and appropriately qualified

Requirements in terms of providing advice

- IFAs must carry out a 'fact find' that covers detailed information about individual's circumstances, goals and attitude to risk
- They may recommend specific products provided that they have taken reasonable steps to ensure that the recommendation is suitable for their client
- Their advice comes with guarantees and protections so that, if an individual receives unsuitable advice and consequently suffers financial harm, they may seek redress

[33] www.moneymarketing.co.uk/evalue-launches-simplified-advice-service/
[34] APFA (2015)

Costs associated with regulation are highest (as a proportion of costs) for smaller firms, and are increasing

Research conducted by the Association of Professional Financial Advisers (APFA) found that, in 2014/15, those small to medium-size firms (under £1 million turnover) that took part in the survey spent, on average, 12% of their regulated income on direct and indirect regulatory costs. The extent to which these costs relate to activities that the organisations would have had to undertake in any case is not clear.

For smaller firms, with less than £100,000 turnover, the percentage increases significantly to around 28% of revenue (an increase on costs in 2013/14 of 20%).[35] This suggests that smaller firms may face particular challenges around providing advice to individuals with modest pension pots. This is because these individuals may be unwilling or unable to pay the level of fee that would be acceptable to smaller firms who pay over a higher proportion of their revenue in regulatory costs.

The introduction of scalable financial advice solutions, such as robo-advice, may lead to the supply of advice at relatively low cost and represent a good fit with people affected by the pension flexibilities

Robo-advice is described as an online service that provides automated algorithm-based management advice, typically without the use of a human financial planner.[36] This contrasts with the past, in which financial advice has typically been provided person-to-person. Wealthier individuals may have been more prepared to pay higher fees than less wealthy individuals on the basis of higher gains from effective financial advice. Until April 2015, individuals with fewer retirement resources were required to annuitise and, therefore, did not typically require financial advice at retirement.

Under the new pension flexibilities, there is a group of individuals, with relatively small pension pots and who may benefit from financial advice at retirement but may not be prepared to pay for it. Scalable solutions with lower fees may be cheaper for these consumers and, with larger numbers using these solutions, may provide a commercial proposition to providers. Compared to the free guidance services, these have the benefit of offering a product recommendation. It remains to be seen whether widespread awareness and access to robo-advice would stimulate the demand for it.

International examples can provide some limited insight into possible directions of travel

While approaches taken in Australia and the US may help inform UK approaches, they are limited in the following ways:

- Aspects of the Australian system are becoming standardised to ensure that individuals access appropriate defaults whereas the UK pension flexibilities may mean that individuals take increasingly diverse approaches to the management of their retirement income.

[35] APFA (2015)
[36] www.investopedia.com/terms/r/roboadvisor-roboadviser.asp

- The use of robo-advice in the US has focused on accumulation and has typically been used by wealthy individuals who trust a digital proposition. Therefore it has targeted a group that differs from the group of high risk DC savers under consideration in this report.

Issues around access to advice have been noted in Australia where it has traditionally been those wealthy individuals who have accessed holistic advice, contrasting with consumer preferences for piece-by-piece advice.

In response, the government focused on enabling Super Funds (pension funds) to provide 'scaled advice' limited in scope, similar to what is called 'simplified advice' in the UK. It published regulations in July 2009, (RG200 regulations) to offer guidance for super funds for 'intra-fund advice', on the condition that the individual's pension funds are not transferred into another fund. This could involve providing factual information, general advice and personal financial advice on topics such as making additional contributions (Chart 6).

Chart 6

In contrast with the UK pension system, individuals' pathways within the Australian system are becoming standardised, e.g. all pension funds are required to move the balances of default members into a MySuper product, which must offer a single diversified investment strategy or a lifecycle investment strategy. This suggests that there will be increasing use of defaults and standardised pathways in Australia, particularly in retirement, making the delivery of advice straightforward relative to the UK where individuals may wish to pursue different approaches, particularly in retirement.

For this reason, there are concerns that this type of simplified advice may lead to poorer outcomes in the UK where this advice addresses one element of an individual's financial situation without taking account of their wider financial position.

Despite this, the Australian approach provides some insights that may be useful for the development of financial services in the UK:

- In order to sustainably deliver intra-fund advice on this ambitious scale it is widely thought that all funds will ultimately have to move to delivery of self-help advice tools as a key channel of delivery of simple personal advice.
- There is frequently no direct charge by the Super Funds for simple advice. Some funds charge a one-off fee for simple advice on areas such as transition to retirement (A$200 to A$500) and full advice can cost from A$1,200 to $3,000.
- Scaled advice is provided through a variety of models, across phone, webchat and other web-based tools, face to face and workplace services, alongside options for general (information-only) and more holistic advice services.
- Funds generally use triage to identify those individuals who require full advice.

The use of robo-advice for pensions emerged in the US, aimed at younger groups during the accumulation phase. The end-users were already familiar with digital processes and therefore accepting of a digital proposition. Companies such as Nutmeg offer a similar approach in the UK.

Chapter three considers ways in which the advice and guidance gap might be reduced.

Chapter three: approaches to consumer financial advice and guidance in the DC market

This chapter considers how the gap for consumer financial advice for the high risk savers might be reduced. It looks at how demand and supply for financial advice might be influenced. It goes on to consider the potential role for defaults in the consumer advice market. At this stage, these are exploratory suggestions around approaches that might be effective, as these have not been formally evaluated.

Demand for and supply of financial may need to converge further in order to address the advice gap

In the absence of this convergence there are potential macro-economic consequences where retired individuals do not receive appropriate guidance or advice and, as a result, risk having lower incomes through sub-optimal use of their retirement funds. With consumption typically declining with age, it has been noted that lack of consumption by older people could limit economic output, potentially worsening the UK's economic position.[37] While it may not be the case for all individuals that an increase in their retirement income leads to increased spending, there is a risk that levels of consumption will decrease for those individuals who spend down their retirement savings prematurely.

Box 3 considers how demand for and supply of financial advice might be influenced.

Box 3: Approaches that could influence demand and supply for financial advice

Approaches that centre around changing demand:

- Increasing appreciation of the value of advice
- Increasing the acceptability of fee levels
- Improving trust in financial advisers
- Increasing demand for free guidance

Approaches that centre around changing supply:

- Reducing cost of advice through innovation and competition
- Reducing cost of advice to the individual through subsidised provision of advice
- Increasing supply of advice

Underlying both approaches is an attempt to bring demand and supply in line so that the cost of advice is at a level acceptable to both the customer and an adviser or provider. Similarly, the types of services on offer should meet the needs of respective customer groups.

Trust in financial services is low, takes a long time to build and will depend on actions across the financial services sector, as well as those of other industries such as the media. Therefore, this report does not make these type of cross-

[37] Brancati, et al (2015)

cutting recommendations that would rely on approaches to be taken by multiple players.

A lack of trust and appreciation of the value of advice are compounded by lack of consumer knowledge and understanding, so that consumers find it difficult to assess the extent to which they should trust and value the financial advice and guidance that they are receiving. Therefore, this report provides an overview of the following demand-side approaches:

- Approaches taken by employers to improve financial wellness of their employees.
- Approaches that might increase awareness and emphasise the value of guidance.

Employers could influence demand for financial advice by taking steps to improve financial wellness of their employees, potentially addressing issues around trust in financial advisers and powerlessness around financial decisions

This may lead to increased appreciation of the value of advice and improved trust in financial advisers, as employees may be better able to assess the value and suitability of any advice that they receive. Similarly, increased understanding may lead to individuals feeling less powerless with regards to financial decisions, removing one of the barriers to seeking financial advice.

Under current tax rules it would be possible to use the rules that employers can provide £150 of pension advice per year tax-free to employees to provide this type of advice or guidance to individuals as a tax-free benefit. However, if an employer provides advice to the value of more than £150, the whole amount is considered to be a 'benefit-in-kind' and the tax-free element is lost.

Approaches taken by employer can range from providing free financial advice to more generic financial education, and has been introduced by some UK employers. It may focus on discrete areas such as encouraging pension saving, dispelling myths around finances and information regarding share options. Other employers have invested in more general financial education that reflects their specific group of employees' needs.[38]

Benefits are also considered to accrue to the employer, including

- a better financially educated workforce has more control over their lives, including working lives
- better understanding of businesses pressures
- reduction in stress and absenteeism related to financial pressures
- greater appreciation of benefits

These approaches have not typically been formally evaluated. However, the Save More Tomorrow initiative, in the United States where employees pre-commit to increase pension contributions after each pay rise, found that take-up tended to be higher where employees were provided with financial advice.[39]

[38] www.cipd.co.uk/binaries/workplfineduc.pdf
[39] Thaler and Benartzi (2004)

Where the focus of the education is narrow, this may not help to improve individuals' interactions with financial advisers and guidance providers. However, where these approaches equip individuals with the skills to better assess the quality of financial advice, this could increase levels of trust and appreciation of the value of financial advisers.

More targeted advertising of Pension Wise may increase awareness of financial guidance and contribute to increased demand for free guidance

While satisfaction levels with Pension Wise have been high and the service is potentially valuable, take-up has been low relative to expectations. This suggests that there may be a group for whom Pension Wise guidance may be beneficial who is not accessing it.

During March 2015, shortly before the introduction of the pension flexibilities, there was a campaign informing individuals about Pension Wise that covered print and digital channels, as well as television. However, the period of 'purdah' before general elections, that blocks advertising of government campaigns, restricted communication of the service to print and digital channels only. This may have limited the exposure of individuals who were retiring in the future to information about Pension Wise at a time when the pension flexibilities themselves received a lot of publicity and when there may have been some pent-up demand for guidance due to people delaying accessing their pension funds, waiting for the introduction of the new flexibilities.

It is not possible to assess what impact this may have had on the take-up of Pension Wise. It illustrates, however, the importance of timing any publicity.

Trust-based pension schemes and pension providers are required to signpost individuals to Pension Wise. This approach then relies on individuals reading and acting on such information.

Employers may provide an important channel for the advertisement of Pension Wise to their employees. However, research suggests that some employers' awareness of Pension Wise is low; only a quarter of Small and Medium Enterprises (SMEs) surveyed in April 2015 were aware of Pension Wise.[40]

This suggests that there may be opportunities for more targeted advertising of Pension Wise and other guidance.

On the supply side, the use of robo-advice and guidance is emerging in the UK and may reduce the cost of advice so that it is perceived to be affordable

The use of robo-advice and online guidance ranges from discrete automated elements during the advice process to fully-automated advice processes. Furthermore, robo-advice tools can be offered direct to the customer, as a 'white-

[40] www.nowpensions.com/press-release/over-half-56-of-employers-are-unaware-of-pension-wise-or-the-april-reforms/

label' tool through employers, or potentially for use by IFAs. As such, robo-advice does not automatically fill the supply gap identified, but is one way of speeding up or improving the processes of accessing more consumers through reduced costs and new channels.

To date, the use of robo-advice in the UK has focused on helping individuals to manage their investments during their lifetime and prepare for retirement. In some cases, services are provided to employees via their employers. As this is typically advice, providers are FCA-authorised where required. These approaches include:

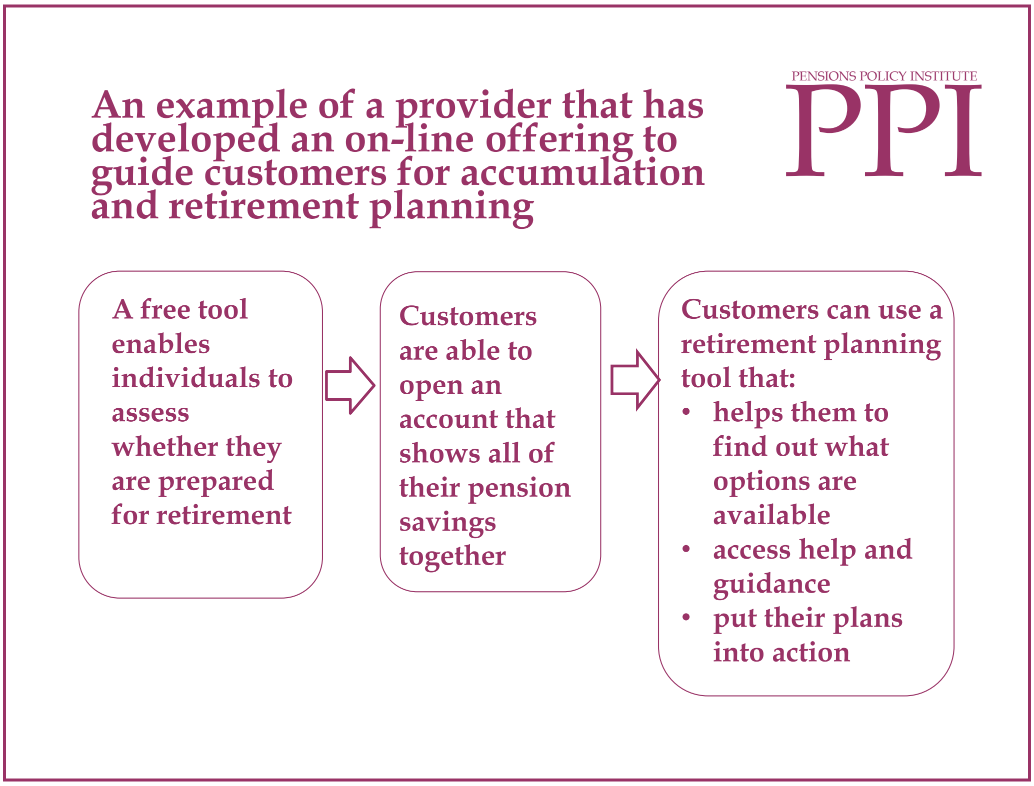
- Platforms that individuals can use to manage their own pension investments.
- Websites that help individuals to set their target retirement income and to keep on track to meet this.
- Websites that assess individuals' attitudes to risk during the accumulation phase, choose investments for them and subsequently builds their portfolio. Fees are between 0.3% and 1%.

The robo-advice described above typically focuses on helping individuals to accumulate adequately for retirement and does not necessarily enable individual to make decisions around how to access their retirement income.

Approaches are also emerging that aim to support individuals in making decisions around how to access their retirement income.

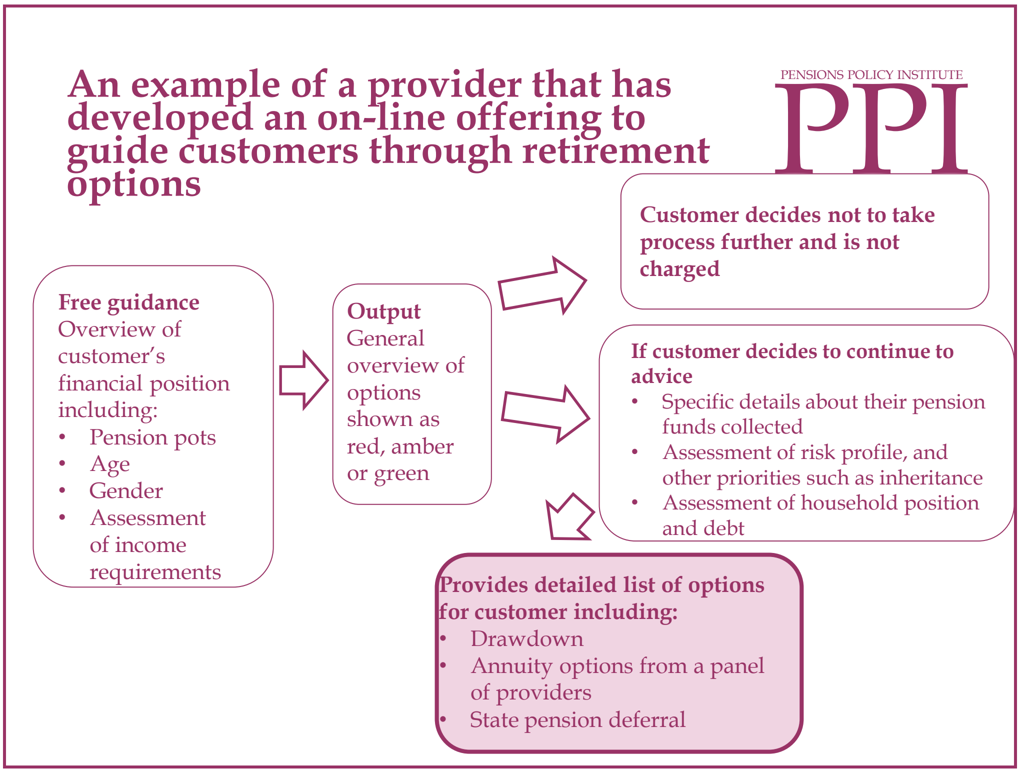
A resource that enables individuals to assess whether they are ready for retirement, helps them to assess the options available to them and to put into place their preferred option is described in Chart 7.

Chart 7



A resource that focuses on options at retirement is described in Chart 8. This is an approach made up of two stages. In the first stage, an individual inputs limited data to ascertain what options they may have for their retirement income. If these options are acceptable to them they may progress to full regulated advice, described as 'humanised automated advice'.

Chart 8



The following points are specific to this service:

- The initial guidance is free and the customer can subsequently pay for full humanised automated advice.
- Where they finally choose an option, they will go through this with a qualified adviser to ensure that the report is accurate and reflects their actual situation.
- Where an individual's circumstances are more complicated they may be referred for person-to-person, rather than automated advice.

While robo-advice and online guidance are becoming more popular, there may be some drawbacks

The guidance and advice described above is important because it targets groups of individuals who have not traditionally sought financial advice. However, the use of fully-automated advice may still be subject to the behavioural barriers that cause a reluctance to seek or take advice in the first place. Actual levels of take-up of these services, therefore, remain to be seen.

Additionally, it is not yet possible to assess the effectiveness of robo-advice and online guidance in terms of use or optimisation of retirement outcomes. There is a possibility that, even with full automation, some extent of human contact is still required or desirable. This could be to either provide validation that information is correct or to provide support and guidance for those who do not understand the process.

In order to provide this type of service, advisers are required to make an initial outlay on the basis that they will attract sufficient customers to recoup these costs. This type of option may only be available to larger adviser companies.

However, any robo-advice solution will need to be sufficiently robust to deal with current market concerns around the risk of mis-advising people, as well as the potential for scamming.

The cost of some types of advice could be reduced by the provision of vouchers so that it may be perceived as affordable to the individual

Her Majesty's Treasury (HMT) recently issued a consultation around public financial guidance and made reference to a possible model of government-backed voucher scheme 'whereby a consumer could be provided with one or multiple vouchers for financial guidance or advice sessions which could be redeemed with a range of accredited partners.'[41] This may be limited to guidance or may extend to financial advice, and the face value of the voucher is not clear.

This is an area that may benefit from more detailed research.

Potential advantages of a voucher scheme include:

- Raising awareness of financial advice
- Normalising financial advice
- Providing individuals with the right contacts if they require financial advice in excess of the voucher value
- Under current tax rules employers can provide £150 of pension advice per year tax-free to employees as a tax-free benefit (this would apply where the employers rather than the Government provided the voucher).

However, risks around voucher schemes include increases in fraud, customers incurring unexpected costs (where the value of the advice exceeds the voucher value) and the provision of low quality advice. There are also concerns around stimulating demand for financial advice where there may not be the supply to meet this demand. It is not yet clear who would meet the cost of the voucher, the level at which the voucher should be set.

There may be positive consequences for the economy if the provision of vouchers lead to individuals taking advice that enables optimisation of the use of their retirement funds and, in turn, lower levels of reliance on means-tested benefits.

There are also potential macro-economic consequences where retired individuals have higher incomes through optimal use of their retirement funds. With consumption typically declining with age, it has been noted that lack of consumption by older people could limit economic output, potentially worsening the UK's economic position.[42]

[41] www.gov.uk/government/consultations/consultation-public-financial-guidance
[42] Brancati, et al (2015)

In the context of the new pension flexibilities, optimisation of use of retirement funds could limit some of the negative impact of an ageing population on economic output. Therefore, effective management of retirement savings could be beneficial in the following ways:

- Optimal management of their retirement funds may lead them to having higher incomes in retirement.
- This may also help them to avoid the negative consequences of prematurely exhausting their pension savings.

While it may not be the case for all individuals that an increase in their retirement income leads to increased spending, there is a risk that levels of consumption will decrease for those individuals who spend down their retirement savings prematurely.

The use of default strategies could be an alternate or complementary approach

An alternate or complementary approach would be to increase the use of default strategies in retirement that might be used with or without financial advice. These have been used in the UK during the accumulation phase where automatic enrolment harnesses individual's inertia with the aim of increasing pension contributions.

The effectiveness of defaults depends on whether there is sufficient common ground between groups of DC savers approaching retirement to inform the design of new defaults, or a limited set of choices, that can support them into retirement even if they fail to engage. Other PPI research has explored this in greater detail.[43] An approach that is currently being considered by a Master Trust includes placing specified segments of an individuals' retirement savings into an income drawdown fund, a cash lump sum and a deferred annuity. The extent to which individuals would be defaulted into this option is not clear.

While the aim of financial advice is typically to optimise outcomes for an individual, the aim of defaults is to minimise the risk of negative outcomes. Despite this, there may be scope for defaults and advice to be used in conjunction with each other.

While the approaches to advice or guidance described in this chapter may constitute important tools to help individuals manage their retirement savings, they are unlikely to provide certainty around outcomes. This contrasts with the period preceding the new pension flexibilities in which annuities provided some level of certainty at a cost to the individual. Regardless of whether individuals use guidance, advice or defaults, a challenge remains around how to communicate this type of uncertainty in a way that enables individuals to make choices about their retirement savings.

[43] PPI (2015)

Conclusions

There is a group of Defined Contribution (DC) savers who are most at risk of making sub-optimal decisions and where support is needed most, and who face both practical and behavioural barriers to seeking advice. This unwillingness to seek advice interacts with the lack of availability of affordable solutions to create an 'advice gap'.

Concerns centre on the risks to the quality of life of these individuals if they prematurely exhaust their pension savings. However, there are also consequences for the economy if these groups rely on means-tested benefits having utilised their pension savings.

The introduction of scalable financial advice solutions, such as robo-advice, may represent a good fit with the needs of this group as it may provide a supply of advice at low cost that could be perceived as affordable. Advice providers may be able to recoup their costs by charging relatively low fees to a large number of customers. However, the extent to which this might address behavioural barriers to seeking advice is not yet clear as data is not yet available to enable an assessment of outcomes of robo-advice and online guidance.

While the Financial Conduct Authority (FCA) has sought to provide clarity, there remains the risk that confusion around what constitutes 'advice' may hinder the development of approaches. In addition, there may remain a group of individuals that online solutions fail to reach and who may require other solutions to the provision of financial advice.

Interventions may include increased publicity around Pension Wise and financial wellness programmes provided by employers. Publicity around Pension Wise could address barriers around awareness of financial guidance. Employer-provided financial wellness programmes could equip employees to assess the financial advice that they are accessing, potentially improving trust in financial advice. They could also address feelings of powerlessness that individuals have with regards to financial decisions.

The introduction of vouchers for free financial advice or guidance is another approach as they could remove barriers around affordability of advice. There could be consequences for the economy if the provision of vouchers leads to individuals taking advice that enables optimisation of their retirement funds and, in turn, lower levels of reliance on means-tested benefits.

An alternate or complementary approach would be to increase the use of default strategies in retirement that might be used with or without financial advice. However, the effectiveness of defaults depends on whether there is sufficient common ground between groups of DC savers approaching retirement to inform the proactive design of new defaults, or a limited set of choices, that can support them into retirement even if they fail to engage.

These approaches to advice and guidance are unlikely to provide certainty around outcomes. Regardless of whether individuals use guidance, advice or defaults, a challenge remains around how to communicate this type of uncertainty in a way that enables individuals to make choices about their retirement savings.

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