PENSIONS POLICY INSTITUTE

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Executive Summary

This PPI report, *Supporting DC members with defaults and choices up to, into, and through retirement: Qualitative research with those approaching retirement*, is the first stage in a two stage research project, sponsored by State Street Global Advisors. It draws heavily on insights from new qualitative research with DC savers approaching retirement conducted by Ignition House, a research consultancy specialising in financial services. The purpose of the qualitative research is to explore preferences for how those approaching retirement might want to draw an income, the trade-offs that they are willing to make in retirement, and the potential to develop default products and strategies that could support them.

The report builds on the findings of the first report in the series *How complex are decisions that pension savers need to make at retirement?*, which found particular challenges with levels of financial engagement and numeracy amongst those expected to be the most reliant on their DC savings, suggesting a need for either personalised guidance and advice or robust defaults that can protect consumers from the greatest risks. This new report focuses specifically on the potential for offering default investment and drawdown solutions for accessing retirement income to DC members.

This research aimed to target groups with sufficiently large pension pots that they might prefer to leave these invested rather than withdrawing them in their entirety as a cash lump sum. For this reason, as a group, the participants in this research have above average levels of DC pension savings and, therefore, the findings should not be taken to be representative for all DC savers.

The research comprised of 33 face-to-face interviews and 3 focus groups with 22 individuals approaching retirement (aged 55-70) and for whom DC savings make up the majority of their private pension savings.

While this group have made preparations for retirement, they have not thought through their financial position or their spending needs in any detail…

- Participants typically have a range of pension investments, including more than one DC pension, or a DB pension, and where there is a partner, retirement planning is typically done on a joint basis. It may therefore be difficult to make too strong or specific assumptions about how savers wish to use a given DC pension pot.
- Phased or flexible retirement is increasingly seen as the norm, with those approaching retirement often expecting to work for some years beyond State Pension Age. Planning horizons are short, focusing on the next year or two rather than long term income needs – making it difficult to engage savers with detailed retirement planning ahead of, or even at, retirement.

- Those individuals interviewed tended to overestimate what they need for their essential spending in retirement – however once they were taken through a budget planning exercise they typically find that they need around £10,000 to £15,000 in the early years of retirement, falling later in retirement. This demonstrates the importance of a more detailed assessment of needs and budget planning compared to more simplistic replacement rate approaches.
- 55-70 year olds who took part in the research tended to underestimate their life expectancy compared to national projections, therefore underestimating how long their pension pot might be required to last. More worryingly they significantly underestimated their chances of surviving to older ages (for example, beyond age 90), suggesting they may fail to understand the importance of protecting themselves against longevity risk and the value of insurance style products including annuities.
- Generally stated preferences are to take a lump sum at the start of retirement (often using the tax-free cash lump sum) and then draw a gradual income, sometimes taking more out in the early years when they expected to be most active. However it isn't always appreciated how taking a lump sum might impact on their remaining income over the course of the retirement.

… And they are unlikely to be well placed to make decisions about investments either in the run up to, or during, retirement.

- The 55-70 year olds spoken to were not confident with equity markets or making direct investments themselves and tended to invest their non-pension savings in cash-based investments such as ISAs – suggesting that pension savings accessed as one or a series of lump sums may simply be placed in "safe" or low-return investments.
- This was sometimes combined with occasional false confidence in their ability to invest in something "safe" or "better" outside of a pension. This typically included either cash investments or property but there was evidence that the tax implications of drawing down all of a pot at once had been missed by some and few had considered the associated costs and level of risk of investing in property.
- Awareness of how pension savings were currently invested was extremely low – there was some recognition amongst a small number of those interviewed that their pension savings were held in a form of default fund but they generally had no idea what that meant in terms of the underlying investments.
- When prompted, those interviewed did begin to understand that default investment funds in the run up to retirement targeting annuity purchase at a set age may no longer be suitable for them, and were very supportive of the idea of being offered default funds into and through retirement. Some even felt that pension providers had a "duty" to provide these.

- There is some indication that those approaching retirement do begin to engage more with their pension pot, however even those planning to retire within the next 2 years had an open mind around whether and when this might happen in practice, and the options that would be available to them. They were largely unwilling to engage with the idea that they might be able to choose how they would be likely to access their assets five or ten years in advance of the retirement date.

While they initially place a very strong emphasis on capital protection and ease of access they are willing to make trade-offs…

- Those interviewed were initially drawn to investment options in retirement that involved them taking little or no investment risk to protect their capital and guard against losses.
- However, they lacked any understanding of how investment choices might interact with the average level of income they might receive over the course of their retirement and, in particular, how some risk might be required to deliver investment returns that can protect them against inflation. It therefore seems likely that individuals may need some nudging or guidance to understand their acceptable levels of risk given their wider preferences. This is something that the Guidance Guarantee might look to achieve. This also highlights challenges around the provision of advice to those DC savers with relatively modest pension pots, who have not traditionally purchased advice.
- Along with the amount of risk associated with a given default drawdown strategy, the participants also selected ease of access, flexibility and income profile as important features. Again, once the trade-offs were explained to them they were often willing to sacrifice some flexibility and lock away at least some of their pension pot for a fixed period, typically 5 years at most, to secure a higher return.

… And after discussion could start to give some clearer indications about their preferences.

- There was consensus that different circumstances and lifestyles in retirement might mean that there would be a need for some limited amount of fund choice outside of a default option – perhaps 3-6 fund choices in total – with individuals recognising their inability to cope with too many investment choices.
- Initially 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 for. Understanding how quickly money would run out if entirely invested in safe assets, and how that interacted with their uncertainty around life expectancy and the possibility of reaching very old ages, was an important eye opener.
    - When weighing up their options, those interviewed generally shifted from not wanting exposure to any risk to being willing to be exposed to potential losses of around 10% (but no more than

20%) of their pension pot to give them a greater chance of income growth and inflation protection.

- They were also willing to forego some flexibility around their ability to access their fund at short notice to improve their investment returns – albeit recognising that they might require easy access to a fixed amount (e.g. £10,000).

The idea of being pre-committed or locked into specific courses of action in retirement was not popular but the concept of longevity insurance did resonate with DC savers.

- While recognising the potential difficulty of making financial decisions later on in retirement, those interviewed were generally resistant to the idea of a pre-determined or assumed course of action, e.g. being locked or rolled over into an annuity from a set age, as they wished to retain flexibility to deal with unexpected life events.
- The majority of those spoken to were however warm to the concept of some sort of longevity insurance product to act as a "safety net" against the risk that they might live too long and/or draw down too much income in the earlier years of their retirement.
- A high upfront cost was a significant barrier but the idea of making gradual payments towards an insurance style product (rather than an upfront one-off lump sum to purchase a deferred annuity) did appeal. In discussion annual premiums of between £500-£1000, starting at age 65, were not seen as an unreasonable amount to secure a lifetime income, e.g., £5,000 per annum from age 85 onwards.
- However, some still felt that this was too much of a 'gamble' and would prefer to take their chance on running out of money.

The key conclusions of this interim stage of the research for the pensions industry, including insurance company platforms, asset managers, trustees and employers, are as follows:

- The Budget freedoms are generally viewed as popular with DC savers, largely because of the negative associations in the financial press around annuities and the notion of handing over your money. However, when savers begin to understand the scale of choices and trade-offs involved in how to access their DC pension pots at retirement they quickly become daunted. This suggests that disengagement and inertia amongst consumers from April 2015 is a key risk without effective processes in place, either through access to guidance and advice or the provision of appropriate defaults.
- There are some specific risks identified within the research which policy makers, regulators and the pensions industry should work together to address, specifically around:
    - Reluctance or inability to plan beyond the next few years, which means locking into a specific course of action either before or at retirement is generally unpopular;

  - Poor understanding of both spending needs throughout retirement and likely life expectancy and, in particular, the probability of living beyond older ages, which means some DC savers are likely to underestimate the importance of having some form of longevity insurance;
  - Lack of engagement (even very close to, or into, retirement) and a willingness to accept a provider default or invest where one is offered– leading to the potential for consumer detriment if the defaults offered are not suitable and designed in the best interest of savers;
  - Perceptions that there are "safer" or "better" investments outside of pensions, which when probed are based on misguided beliefs or have not been properly thought through.
- The idea of being offered a default investment or drawdown option into retirement resonates with DC savers – though they recognise the importance of wider individual and household circumstances and the need for there to be some element of choice for those who want it. There is a degree of commonality, once thought through, around the appetite for investment risk and growth in their pension savings post retirement and their willingness to sacrifice capital protection and ease of access.
- Given the existing lack of any understanding around the underlying investments in default funds, and what the funds are seeking to achieve, it will be important that any defaults and alternatives offered are clearly branded and communicated in terms of their levels of risk and objectives.
- DC savers may be reluctant to make upfront commitments about when they might lock into a certain course of action, or to hand over significant sums of capital in the early years of retirement to another party, such as an insurer. Whilst these may act as barriers to the take up of some forms of annuities, concepts like longevity insurance and the payment of ongoing premiums did resonate with the majority of those interviewed, and they were willing to make some sacrifices in income in early years to ensure they had a secure backstop should they live to higher ages.

The second stage of this research will build on these findings to explore the potential communication challenges around comparing different options for DC savers at retirement, with a particular view to exploring the tools, visuals and rules of thumb that might help to benchmark different options. This will be particularly relevant in the post-April 2015 retirement landscape where taking a fixed and guaranteed income stream (through an annuity) may not be the norm but where those unwilling or unable to take financial advice may still need to feel comfortable with their choices or any default solutions being offered to them at retirement.