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What's been happening and what's on the horizon in the world of pensions

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After a lifetime of saving, most Defined Contribution (DC) savers seek both income security and flexibility from their accumulated DC pots when targeting a desired standard of living in retirement. In this edition of Pensions Watch, we look at the considerable risks and challenges the decumulation decision-making process poses and how we might solve for these if more optimal retirement outcomes are to become the norm.

A brief retrospective

The fundamental basis of any pension system is to provide a secure long-term income stream to meet spending needs in retirement. This much is clear from both the OECD and the authoritative annual Mercer CFA Institute Global Pensions Index.[1] Prior to the introduction of the freedom and choice reforms in April 2015, this objective was largely met with over 90% of UK Defined Contribution (DC) pension pots being, mainly mandatorily, annuitised – usually net of 25% tax-free cash.[2]

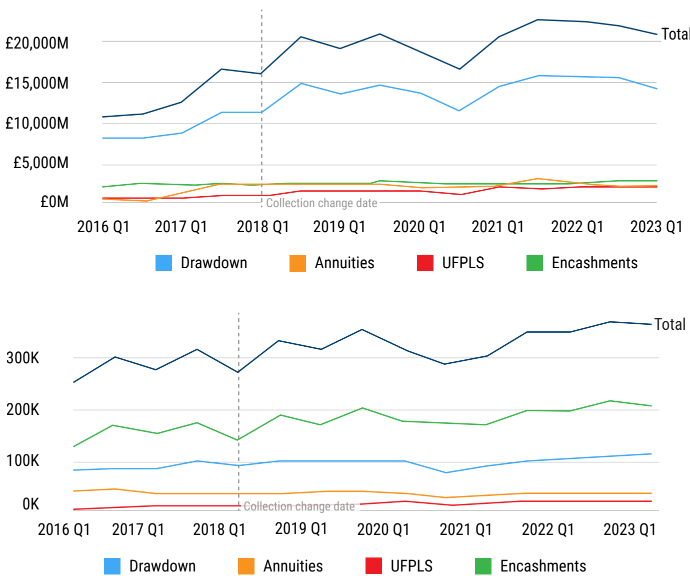
However, for the past nine years there's been complete flexibility as to how DC pension assets can be accessed[3] from age 55,[4] whether as cash; via income drawdown, from which an income (flexi-access drawdown) or a series of lump sums (uncrystallised fund pension lump sums - UFPLS) are drawn and a legacy may be left; via an annuity which will provide a guaranteed level, variable or escalating income for life; or a combination of each of these options. Indeed, unless people mix and match, ultimately they must trade off the income security and certainty of an annuity against the flexibility but uncertainty of taking one or a series of cash lump sums and/or an income via income drawdown.

One succinct way to think about decumulation today is as two tightly-interlinked problems: an investment one – how should I invest my money? – and a planning one – how much should I take from my pot and what pattern of income do I want or expect in the future? In the pre-freedom and choice era, the planning decision was determined in advance and so the investment problem became relatively easy – basically it was only an accumulation problem.

1 See: OECD (2022) Recommendations of the council for the good design of defined contribution pension plans. Also see: Mercer (2022), Mercer CFA Institute Global Pension Index, accessed at https://www.mercer.com/assets/global/en/shared-assets/global/attachments/pdf-2022-mercer-cfa-global-pension-index-report.pdf
2 See: retirement-outcomes-review-interim-report.pdf (fca.org.uk). 466K annuities were purchased at their peak in 2009, at which point 25K drawdown contracts were purchased. Despite the introduction of income drawdown in 1995, and limited provision to take small pension pots as a cash lump sum, before the freedoms were introduced various conditions were attached to income withdrawal via drawdown, including a requirement to annuitise by age 75. On the announcement, in 2014, of forthcoming pension freedoms the number of annuities purchased fell dramatically to 189K, then declining to 82K and 75K in 2015 and 2016, respectively. Source: The DC Future Book: in association with Columbia Threadneedle Investments. 2023 edition. Lauren Wilkinson, Daniela Silcock and John Adams. The Pensions Policy Institute. September 2023. p.32. Note: this latter source derived these numbers from ABI, not FCA, data. Dispensing with compulsory annuitisation post-freedom and choice has resulted in the UK being continually marked down in the Mercer CFA Institute Global Pensions Index's annual assessment of global pension systems.
3 In his 19 March 2014 Budget speech, Chancellor George Osbourne caught everyone by surprise in announcing, "Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want. No caps. No drawdown limits. Let me be clear. No one will have to buy an annuity."
4 The minimum age from which DC pots can be accessed will rise to 57 from 2028.

How have DC pots been accessed since April 2015?

Figure 1: Pots accessed for the first time since April 2015



Source: FCA Retirement Income Market Data 2022/23. 16/4/24.[5]

A number of themes and trends around how savers are accessing their DC pots can be gleaned from the recently released Financial Conduct Authority (FCA) Retirement Income Market Data, which principally analyses the period April 2022 to March 2023, and selected other sources.[6] Firstly, between 250K and 370K pots have been accessed for the first time each quarter since Q215, with more than £200bn having been accessed for the first time since Q218. Secondly, after an initial "dash for cash" in 2015/16,[7] the data has since followed a now familiar pattern. The number of partial and full encashments, mainly of smaller DC pots, have regularly far exceeded the number of drawdown contracts purchased which, in turn, have far exceeded the number of annuities purchased. However, in cash terms, the amount invested in drawdown trumps all else, typically representing more than double the amount invested in annuities. Additionally, around 85% of annuity purchases have typically been for a level, rather than an escalating or index-linked, income.[8]

Another visible trend has been the number of those tapping into, free-to-access, Pension Wise guidance[9] and/or seeking regulated advice before making a decision. For drawdown purchase, whereas before freedom and choice about 90% of purchases were made with advice, since 2015 only around 60% have sought regulated advice, with just under 10% taking advantage of a Pension Wise call. For annuity purchase, the percentages for both seeking advice and engaging with Pension Wise have regularly been around 30% and for full encashments and UFPLS around 25% and 10%, respectively.[10]

A number of other points stand out from the data:

- **In Q123**
  - 52% of new drawdown contracts were for amounts of £50K+,[11] with 70% of drawdown contacts being invested for those aged 55 to 64. 44% of this latter group made an initial drawdown of 8%+ of capital – a rate of withdrawal unlikely to be sustained for too long;
  - 33% of new annuity contracts were taken out by those aged 55 to 64, while 47% of annuities were bought from the existing pension provider;
  - 69% of encashments were made by those aged 55 to 64, with 10% of encashments - c.21K withdrawals – being for amounts of £50K+. Of these, over 1,500 were for amounts of £100K to £250K and 221 for £250K+. Prima facie, excepting those encashments taken as tax-free cash, a lot of income tax would have, probably unwittingly, been paid on these withdrawals by the latter two cohorts;
- Between April 2022 and March 2023, 8%+ withdrawals from drawdown were highly prevalent for pot sizes up to £100K, prevalent for pots sizes of £100K to £250K but less so for pots of £250K+, for which advice was typically sought. This suggests that many, far from planning a sustainable lifetime income stream, were instead adopting a myopic approach to satisfying their living standards, without giving too much thought to the long term.

Separately, the Association of British Insurers (ABI) announced a strong uptick in annuity sales during 2023, with the number and amount invested increasing significantly on 2022. Although the 72,200 contracts purchased at an average size of c.£72K, during what was a much higher yield environment than had prevailed previously, represents the highest number of annuities purchased since 2016, it still is still only 15% of the 466K peak achieved in 2009 and less than 40% of the number purchased in 2014, albeit with a slightly higher total value than that invested in annuities in 2014.[12]

5 Both the FCA and ABI publish decumulation data, albeit each draws on a different data set, so the numbers in terms of contracts purchased, encashments made and advice taken rarely align. However, the broad trends materialising from both data sets tell a similar story.
6 See: Retirement income market data 2022/23 | FCA. Since April 2018, the FCA has employed a different method data collection to that used from April 2015 to March 2018. Other data sources include the ABI and the PPI.
7 300K full cash withdrawals were made between April 2015 and March 2016. Source: PPI (September 2023) op.cit.
8 See: Retirement income market data 2022/23 | FCA.
9 Pension Wise is the free-to-access telephone and face-to-face-based generic pensions guidance service for those aged 50+.
10 See: Retirement income market data 2022/23 | FCA. Also see: PPI (September 2023) op.cit.
11 21%, 18% and 13% of drawdown purchases were for amounts of £50K-£100K, £100K-£250K and £250K+, respectively.
12 2023 sets new post-pension freedoms record for annuity sales | ABI

Decumulation decision making is difficult

"Deciding how and when to start the transition from accumulating wealth into decumulation and retirement is one of the most challenging financial decisions an individual will make in their lifetime"

Robert Vaudrey, Copia Capital[13]

What's clear from the above observations is that most people really struggle with what's been termed, "the nastiest, hardest problem in finance".[14] Not that we should be surprised by this. After all, most of the UK adult population aren't particularly numerate or financially literate, principally as a consequence of the lack of financial education in schools stifling financial decision-making in later life. As a result, most people find even the simplest of financial concepts and calculations unfathomable.[15]

Given this, for those seeking both security and flexibility in decumulation, as freedom and choice intended, the decision-making process is incredibly complex, with myriad largely unquantifiable demographic, health, economic and investment risks to manage allied to a paucity of frames of reference, guidance and accessible advice. Consequently, most people do not know what is feasible or realistic at and in retirement. Couple this with retirement no longer being a one-off event with a well-defined destination point, having to contend with often unforeseen changed circumstances - whether family or financial - along the way and the considerable cognitive, or behavioural, impediments to informed decision making and you have *the* most difficult of life's financial decisions to make.

The behavioural impediments to optimising decumulation decision making

The behavioural, or cognitive, impediments to optimising decumulation decision making are many and varied and typically compound with age.

Top of the list is the fact that moving from a deep-seated lifetime-of-saving mindset to a spending frame, by drawing on an exhaustible, non-replenishing pot of money, demands a fundamental psychological shift of mindset. Consequently, when given a choice of how to utilise their DC pension pots, many savers are reluctant to draw down their pension assets – many simply withdraw the income generated – thereby compromising their retirement living standards, often dramatically so.[16] Of course, at the other end of the spectrum, there are those who operate a myopic approach to retirement spending, where instant gratification trumps adopting a more measured, sustainable approach to consumption resulting in this cohort outliving their retirement savings, sometimes very prematurely.[17] So, whether outliving retirement savings or living in penury in fear of doing so, the risk of individuals sleepwalking into a suboptimal retirement is ever-present. Moreover, this decision making comes at a time in many people's lives when financial literacy and cognitive ability typically starts to decline and is often accompanied by increased risk and loss aversion.[18] Quite the problem then and unquestionably a growing policy issue.

Then there's the degree to which saver choices are sensitive to the way in which options are presented to them. Framing, word choice and the use of numbers really do matter. Indeed, a seminal FCA study suggested that options worded in an income/consumption frame resulted in annuities being predominantly chosen. However, when worded in an investment frame, i.e. referencing likely investment returns with no mention of income/consumption, drawdown was mostly selected. Moreover, low/median income households, typically those who do not seek advice, were more sensitive to framing than higher income.[19] Never was Jean-Paul Sartre's "words are loaded pistols" quote more prescient. As to numbers, single easily relatable numbers trump all else and are an incredible powerful tool to help anchor those who are metaphorically out at sea.[20]

13 Rethinking retirement: changing gear? Copia Capital based on research by the Lang Cat. April 2024.
14 This quote is attributed to Nobel Laureate, Bill Sharpe. See: Max, S (2019) How to solve the 'Nastiest, Hardest Problem' in Retirement accessed at https://www.barrons.com/articles/jimmy-buffett-death-margaritaville-net-worth-9d7b825c
15 Recent evidence includes a TPT Retirement Solutions survey of 2,500 DC members, where only 35% were confident in making retirement decisions, while 68% wanted to target a steady income from a default drawdown solution. See: https://www.tpt.org.uk/news-insights/only-a-third-of-pension-savers-are-confident-enough-to-make-retirement-decisions
16 The US, Australia and New Zealand all have systems that do not require retirees to annuitise their DC assets into a lifetime income. As a recent PPI report notes, "The evidence from these countries is that rather than drawing down their assets in retirement and relying on a State Pension underpin, retirees are reluctant to draw down the majority of their capital. In the US, on average and across all wealth levels, most current retirees still had 80% of their pre-retirement savings after almost two decades of retirement. Although this figure is likely to be weighted to those with the most wealth, even for those in the lowest wealth group, more than half had 50% or more of their assets remaining after 17-to-18 years of retirement. In Australia, maintenance or growth of assets occurs despite policy settings designed to stimulate drawing of assets. As a result, most leave the majority of the wealth they had at retirement as a bequest. Retirees tend to consume only the income from their assets and not the assets themselves. In New Zealand, there is a tendency for retirees to treat KiwiSaver pots as a nest egg, leaving them with their provider or withdrawn and put into a savings vehicle, as they are not confident to use their accumulated assets to fund their retirement." See: What can the UK learn about other countries' approaches to accessing DC savings? Nick Hurman, Pensions Policy Institute. November 2023. p.10. Columbia Threadneedle Investments actively participated as a sponsor in the compilation of this report.
17 As noted earlier, in the UK, this is evidenced by the quantum of full and partial cash withdrawals from DC pension pots continuing to escalate beyond pre-pandemic levels, the Treasury's income tax-take from cash withdrawals far exceeding expectations and FCA retirement income data recording a majority of withdrawals exceeding 8% of capital.
18 Loss aversion is when the pain of financial losses exceeds the pleasure from a financial gain of the same magnitude. Loss aversion often results in a reluctance to invest in those asset classes, like equities that, while volatile in the short-term, typically preserve capital and income in real terms over the longer run, unlike lower volatility assets, like cash.
19 Does the framing of retirement income options matter? A behavioural experiment. Financial Conduct Authority. December 2014. The methodologies and findings of the research were consistent with that conducted by Brown, J.R., Kling, J. R., Mullainathan, S., and Wrobel, V.M. (2008). Why Don't People insure Late-Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle. American Economic Review, 98(2): 304-09.
20 Single relatable numbers typically trump percentages and those numbers that require additional calculations, e.g. converting a pension pot into an income stream.

Of course, the potentially dire consequences of making a wrong decision or suffering decision paralysis will compound over time as Defined Benefit (DB) pensions disappear, people start receiving their state pension ever later in life and increasingly become solely reliant on their DC pensions pots to support their desired standard of living in retirement which, for many, may extend to 30-plus years.

That said, it is also evident from the data, and not unreasonable to expect, that people want control over and ownership of their money. Indeed, it is well documented that people don't like being told what to do, not least by those perceived as strangers (read policymakers), and especially when it comes to their hard-earned savings. That's where cannily employing behavioural science comes in. More on that shortly.

Spending patterns in retirement

Before looking at how we might solve for the difficult decision making that comes with freedom and choice for those seeking income security and flexibility, let's consider retirement spending patterns and how much income people need in retirement. First spending patterns.

Since the 1950s, economic theory has assumed that an individual's spending remains reasonably constant throughout their lifetime, even when making the transition between work and retirement.[21] By contrast, the commonly held view of many in the pensions industry is that spending in retirement is 'U-shaped'. That is, retirement is assumed to start with a spending spree in the 'go-go' years, decelerate in the 'slow-go' years, when the novelty of one's new-found freedom dissipates and morbidity begins to materialise, only for it to skyrocket again in the 'no-go' years as the costs of long-term care surface.[22] Or so the story goes. Empirically, neither economic theory nor the U-shaped spending pattern stand up in practice, with studies around the world suggesting spending in retirement typically follows a downward trajectory in real terms regardless of income level, lifestyle and the period analysed with almost all cohorts progressively *saving* more of their income as they become older.[23] Intuitively, this reduced consumption and increased saving is likely to be driven by a combination of declining health, a desire to provide bequests and much changed personal preferences for goods and services in old age. Needless to say, as retirees enter the no-go years, long-term care needs often surface, though the idiom 'long-term care' is perhaps a misnomer, as the life expectancy of those who remain outside of care homes *far* exceeds that of those within.[24]

But here's the thing. Most contemporary retirement spending studies have been conducted on those either born or who grew up during the Second World War, commonly referred to as *the make do and mend and never let anything go to waste generation*. By contrast, the generation below, the second wave baby boomers of the mid-1950s to mid-1960s and early Generation Xers of the mid-1960s to early-1970s, today's 50 to 60-somethings, adopt a more aspirational approach to life. They also have greater disposable income than their parents, often have considerable DB pension rights and possess the ability to accelerate access to this stream of income via freedom and choice. Crucially, this "sandwich generation" - the first to be simultaneously caring for ageing parents while helping out financially dependent adult children (hence sandwich) and be faced with the rapidly declining economics of social care - may well be the generation whose retirement spending doesn't decline in real terms but continually increases. Moreover, the sheer size of this demographic bulge presents a potential decumulation tsunami.[25] One thing looks increasingly certain though; the U-shaped retirement spending pattern will remain atypical.

21 Variously known as the 'lifecycle hypothesis' and 'permanent income hypothesis', consumption at any point in time is assumed to be driven by the individual's expected average lifetime income, taking account of the likely accumulation and decumulation of physical and financial assets and human capital over their lifetime. See: Modigliani, F. and R. H. Brumberg (1954), "Utility analysis and the consumption function: an interpretation of cross-section data", in K.K. Kurihara ed., Post Keynesian Economics, Rutgers University Press, New Brunswick, pp.388-436. Friedman, Milton (1957). "The Permanent Income Hypothesis". A Theory of the Consumption Function. Princeton University Press. ISBN 0-691-04182-2.

22 The three phases of retirement [65 to 75 (the go-go years), 75 to 85 (the slow-go years) and 85 to 95 (the no-go years)], was coined by Michael K. Stein in The Prosperous Retirement: Guide to the New Reality. December 1961.

23 As a recent PPI report states, "In the US, when adjusted for inflation, spending from age 65 to advanced old age declines for single and couple households at annual rates of about 1.7% and 2.4% respectively. Spending declined for all initial wealth quartiles, with some small variations, suggesting that the decline is not related to economic position. In Australia, successive waves of the Household Expenditure Survey show that for a given cohort, real spending falls once households are aged over 70." See: PPI (November 2023). op.cit. p.10.

24 See: Life expectancy in care homes, England and Wales - Office for National Statistics (ons.gov.uk)

25 Those born in the UK between 1963 and 1971 currently number more than 900,000 for each of these nine cohort years. Additionally, those born from 1972-1976 currently number more than 800,000 for each of these five cohort years. See: Mid-year population estimates, UK. ONS data as at June 2021. Also see: Overview of the UK population, 2020. ONS, 25 February 2022. The ONS estimates that in mid-2020, 22% of the UK's 67.1 million population was populated by those at or over State Pension age (SPa). By mid-2041 this percentage is projected to rise to 26% of a population totalling 70.5 million, as the numbers reaching SPa outstrip the growth in net migration and the birth rate and longevity continues to improve.

So how much income do people need in retirement?

Now to income requirements and where better to turn than to the Pensions and Lifetime Savings Association's (PLSA's) Retirement Living Standards (RLS).[26] Introduced in 2019, the PLSA's RLS helpfully illustrate, via single relatable numbers, what life in retirement might look like for both a single retiree and a couple, either living in or outside of London, at three different levels of spending: minimum, moderate and comfortable.

To make the three high level expenditures relatable, each of the standards, which are based on independent research from the Centre for Research in Social Policy (CRSP) at Loughborough University and derived from working with focus groups, drill down into what could typically be spent annually on household bills, home maintenance, food and drink, transport, holidays and leisure, clothing, personal items, presents and charitable donations. However, rent, mortgage, health and social care costs, which are specific to each individual, are excluded. The PLSA RLS are further humanised via eight personas, each at various stages of their working lives.[27]

For 2024, the PLSA RLS each represent considerable annual expenditures, which have been exacerbated by persistent cost-of-living pressures. Each is as follows:[28]

Minimum
- £14,400 for a single person living outside of London (London £15,700)
- £22,400 for a couple living outside of London (London £24,500)

Moderate
- £31,300 for a single person living outside of London (London £32,800)
- £43,100 for a couple living outside of London (London £44,900)

Comfortable
- £43,100 for single person living outside of London (London £45,000)
- £59,000 for a couple living outside of London (London £61,200)

So how do we solve a problem like decumulation?

Recognising that decision-making at and in retirement has become more complex with considerable risks and scope for error, a greater focus on optimising decumulation outcomes is evident from both policymakers and regulators. Indeed, the Department for Work and Pensions (DWP) has proposed placing trust-based schemes under a legal obligation to provide, or work with a partner in providing, decumulation products and services for members, while The Pensions Regulator (TPR) and the FCA have each set out their decumulation objectives and begun working in earnest with myriad stakeholders to accomplish these objectives.[29]

Something's gotta change

Granted, change is on the horizon but there's still much to do if decumulation outcomes are to become more optimal, not least in determining how best to support, or mitigate, the enormous decision-making burden that comes with freedom and choice.[30]

Although not mutually exclusive, the solution essentially comes down to providing decumulation decision makers with more and better guidance and/or taking away most, if not all, of the decision making through the provision of default solutions.

Is the solution to provide more and better guidance?...

So to guidance, which is integral to TPR's decumulation objectives in giving agency to savers to make their own decisions, via a guided journey that funnels people to tailored and personalised solutions.

Indeed, placing simple, accessible, trusted, timely, well signposted and behaviourally robust guidance – think rules of thumb, on-line expenditure calculators and drawdown modellers – at the centre of decumulation policy and delivering this in a consistent way, to support individual decision making, can lead to desired behaviours, such as overcoming the reluctance to draw down pension assets sustainably to support a realistic standard of living in retirement and addressing myopic behaviour at the other end

26 Following on the back of their Australian counterparts, these Retirement Living Standards originated from the PLSA suggesting, in 2017, the adoption of national retirement income targets as a frame of reference by which to gauge the level of income needed to support a comfortable, modest or basic retirement. See: Hitting the Target – Delivering Better Retirement Outcomes. PLSA. October 2017.
27 The Centre for Research in Social Policy (CRSP) at Loughborough University works with 26 focus groups, comprising 249 members of the public, some working, some retired, across 14 locations, representing a variety of social, economic and cultural groupings. See: https://www.retirementlivingstandards.org.uk/developing_rls_research_report.pdf
28 See: https://www.retirementlivingstandards.org.uk/details
29 In November 2023, TPR set out its five guiding principles and the seven challenges to be addressed if decumulation outcomes are to be more optimal. See: PPI launch November 2023 | The Pensions Regulator and Helping savers to assess their DC pensions savings: the seven challenges | The Pensions Regulator. In March 2024, the FCA published its thematic review of the functioning of the retirement income advice market to establish whether consumers are receiving appropriate advice to meet the complex decision-making challenges they face and ultimately their income needs in retirement. See: Thematic review of Retirement Income Advice | FCA. This was accompanied by a letter to the CEOs/MDs of IFA firms to review their retirement income advice processes. See: FCA asks Financial Advisers to review their processes in retirement income support | FCA. The FCA also published a short guide on the importance of undertaking cashflow modelling in retirement income planning to demonstrate the suitability of retirement-related advice. See: Undertaking cashflow modelling to demonstrate suitability of retirement-related advice | FCA. Moreover, the FCA is "actively considering" whether pensions decumulation should be included within the scope of its advice guidance boundary proposals. See: FCA 'considering' including decumulation within advice guidance plans - FTAdviser.
30 See: Pensions Watch Issue 28. Chris Wagstaff. Columbia Threadneedle Investments. November 2023.

of the spectrum. However, if guidance is to materially improve outcomes through regular engagement, the imperative must be to first define what a good outcome looks like and – given life's twists and turns – to ensure the guidance is regularly revisited. Otherwise, an optimal retirement path is unlikely to be followed.

Guidance in the UK principally comprises two relatively well signposted free-to-access information sources in Pension Wise and the PLSA's Retirement Living Standards (RLS). Pension Wise, the free-to-access telephone and face-to-face-based generic pensions guidance service for those aged 50+, noted earlier, has, by approaching an ultimately complex decision via logical and well framed questioning within a series of simple steps, helped many achieve better retirement outcomes.[31] However, one-off generic guidance from Pension Wise, typically at the point of retirement, is unlikely to be sufficient, given that peoples' circumstances and spending patterns change throughout retirement, sometimes markedly so. Therefore, this aspect of guidance should be applied repeatedly to ensure an optimal path is continually followed. Meanwhile, the PLSA's RLS, also considered above, helpfully illustrate what life in retirement might look like via simple, accessible and relatable single number anchors. Moreover, later in 2026 this guidance will be supplemented by the long-anticipated launch of the Money and Pensions Service (MaPS) pensions dashboard, which will allow individuals to view all of their pensions information, including the state pension, in one secure place.[32] Of course, good guidance must always be simple and easily accessible, as even the smallest number of unnecessary steps or additional effort required by the prospective DC decumulator can derail the whole process. Once again, simple behavioural interventions have a central role to play here.

Employing simple behavioural interventions to guidance

As suggested earlier, framing, word choice and the use of numbers are critical to motivating beneficial behaviours. For instance, using positive words, or priming, and, as noted, employing single relatable numbers encourages positive behaviour. Equally, never underestimate the power of socialising good ideas and behaviours. After all, as social animals, our decisions are rarely made in a detached manner. Instead, we act on the information, opinions and actions of others, especially those we perceive as experts, and like to have our own actions and opinions validated by others. Ultimately, whenever employing simple behavioural interventions, never forget the principles of the EAST framework of making interventions Easy, Attractive, Social and Timely.[33]

Of course, much more can and should be done – perhaps along the comprehensive lines of Australia's Retirement Income Covenant and the New Zealand Actuaries Retirement Income Interest Group's (RIIG) Rules of Thumb[34] – in helping those at and in retirement to gauge what is reasonable and realistic. Indeed, in the latter case, the idea is to help retirees to choose withdrawal rates in an informed manner, based on their retirement needs and preferences. That said, many commentators have suggested that no amount of guidance can substitute for advice. Therefore, the question of how to provide simple and affordable advice to those of a certain age, not least to those who are not tech-savvy, still needs to be answered.

Segmenting retirement income policy

As an adjunct to this, there is a strong case for segmenting retirement income policy between low earners, those on a middle income and high earners. In the UK, as the full state pension provides a high income replacement rate for those on a below median working life income, any accumulated pension savings are best employed as a capital buffer for contingencies and to meet large one-off expenditures. At the other extreme, those with a high working life income are the least likely to require high replacement rates in retirement and be the most likely to seek regulated advice in exercising freedom and choice. However, those with a middle working life income will likely be the cohort to most rely on their DC pension pots to supplement the state pension if replacement rates, hence retirement living standards, are not to be unduly compromised. Therefore, it is this cohort on which UK decumulation policy should principally focus.

31 Although, in April 2022, UK policymakers rejected calls for automatically enrolled Pension Wise appointments, DC schemes and providers can, and increasingly do, voluntarily offer to book members a Pension Wise appointment before they have made a final decision on accessing benefits. Additionally, since 1 June 2022, workplace DC schemes have been required to include a link to the Pension Wise booking tool in response to member applications to receive "flexible benefits". However, this "stronger nudge" may not be enough to make receiving pensions guidance immediately prior to accessing DC benefits, the norm.
32 Although the pensions dashboard's functionality and the presentation of information has yet to be finalised, just as a motorist's SatNav converts speed, distance and known roadblocks into a single ETA, the pensions dashboard needs to convey to the pension saver what their probable end game looks like, in a simple, single, easily comprehended estimated retirement income number.
33 See: EAST. Four simple ways to apply behavioural insights. The Behavioural Insights Team. 2014.
34 As a recent PPI report notes, "In Australia, the Retirement Income Covenant requires superannuation funds to develop a strategy for members who are retired or approaching retirement to help them optimise their retirement income. Funds have the discretion to determine the type of assistance that they provide to their members across a wide spectrum of information, education, assistance, guidance, advice and implementation [though they are required to balance three broad objectives: maximise expected income; manage income risk (longevity, inflation, investment and other) and provide flexible access to funds]. This could result in tailored retirement products, financial tools and education and personalised retirement planning and advice. In New Zealand, the Retirement Commission is focusing on promoting a [direct-to-consumer rules of thumb] framework with supporting on-line drawdown calculators to support individual decision making and reduce the possibility for of financial decision-making errors. They are also recommending that all KiwiSaver providers contact their members at milestones approaching retirement to provide them with access to this information and guidance regarding their options." See: PPI (November 2023). op.cit. p.11, pp.22-23 and pp.24-25. Additionally, the report notes (on p.18) the positive impact on decision making of those "large and mature DC schemes in Canada that have experience of delivering DC decumulation solutions to members [in providing] tools and calculators to assist members in assessing: their risk tolerance and best match asset mixes; the optimal withdrawal rate (consistent with their investment choices and expected remaining lifespan); the potential benefits of combining variable benefits with annuity purchase (either immediate or deferred); and their DC decumulation choices in the wider context of their state and other private pensions and savings and spouse's assets and entitlements."

… Or does the answer lie in most being defaulted to a default?

Moving from one end of the choice architecture spectrum – the paternalistic requirement to annuitise DC pension pots pre-2015 – to the other – by introducing libertarian freedom and choice from 2015 – was, for many people, a step too far. Instead, a libertarian-paternalism halfway house which simplifies and guides choices, while still providing people with ownership and control, is perhaps a better way forward for most people. These so-called soft defaults also play a role in TPR's thinking.

Indeed, the contention of many prominent pension practitioners, commentators and academics is that most people don't know what they don't know. As such, they will never truly engage with the complex decisions to be made at and in retirement, nor will they ever have the confidence and capability to select and successfully manage the retirement solution that most closely meets their needs. Indeed, as noted earlier, even the simplest of calculations and financial concepts are unfathomable to many and few appreciate what is feasible and realistic to achieve at and in retirement.

So where does this leave us? Well, given the success of auto enrolment in the accumulation stage, the idea of auto enrolling people at the point of retirement into an institutionally-managed default that combines the central roles of collectivity, in the provision of income security and longevity insurance, allied to a degree of flexibility and the security of trust-based governance, has, for many years, gained traction. Indeed, for most people, given the behavioural and structural impediments to raising engagement levels, a well thought out default, which offers value for money, with options to finesse the default's parameters and the provision for those, who are better able and willing to make their own decisions, to opt out with advice, is perhaps the best possible option. Of course, in allowing a degree of flexibility for those remaining in the default, which in itself would require more accessible guidance and low-cost advice, the default could be finessed at set times and within certain parameters to meet individual preferences. To prove sustainable, the extent to which each feature could be flexed would, in some cases, be constrained by the flexing of the other features, the individual's age and the size of the remaining pot.

This default, which would likely be underpinned by a well-diversified managed fund with strong responsible investment credentials, could be complemented by a guaranteed minimum income underpin, financed by an element of the DC pot being invested in a level or escalating annuity. This could be further complemented by the purchase of one or a series of deferred annuities,[35] to provide a guaranteed income later in the retirement journey, perhaps in the no-go years when the costs of social care and leaving a bequest come into sharp focus.[36] Once again, the provision of advice is crucial here.[37]

Meanwhile, in Australia…

Australia, like the UK, continues to grapple with the thorny issue of how best to optimise retirement outcomes given unfettered access, initially from age 56, now from age 60, to DC superannuation pots. Unlike in the UK, annuitisation of superannuation pots has never been mandatory in Australia.

Set up in 1992, the focus of DC-based superannuation has, until recently, been on accumulation and not the provision of a secure lifetime income stream in retirement. Indeed, until very recently, those opting for a retirement income stream would typically select an account-based pension (ABP) - a retirement managed fund which didn't protect against investment sequencing, inflation or longevity risk.[38] However, following the Comprehensive Income Product for Retirement (CIPR) recommendation that ultimately followed from the Australian Government's Financial System Inquiry, of 2013-14, variable annuities, effectively a halfway house between the lifetime income guarantee of conventional annuities and the flexibility and potential investment and income growth offered by income drawdown, have steadily gained traction as the predominant retirement solution of choice for those seeking a regular income throughout retirement. Although a complex product if you lift the bonnet to interrogate the underlying mechanics, in essence what variable annuities offer is very simple: relative income security allied to relative flexibility with less decision regret risk than a conventional annuity. That is, a lifetime, albeit variable, income stream, tied to the performance of an investment

35 The attraction to insurers of providing deferred annuities and the rates available to consumers has been enhanced by a higher-yield environment, a move by insurers into illiquid, prospectively UK productive finance, assets and Solvency UK reforms which have resulted in a more accommodating regulatory stance. Separately, NatWest Markets have suggested an innovative approach to deferred annuity purchase, albeit one that is contingent on advice and a change in the way the UK thinks about pension provision. By drip feeding deferred annuity purchase during the latter stages of the accumulation stage and targeting an illustrative vesting age of 65, a minimum level of guaranteed income is secured in decumulation at a known average rate. This is instead of a one-off decision being made, typically at-retirement and being a price taker at that single point in time. See: Deferred annuities: A missing price of the retirement income puzzle? NatWest Markets.12 April 2024.

36 Nowhere is the motivation to save income in retirement stronger than when there is a desire to leave a bequest. Indeed, regardless of age group and income, on average people think they have a 70% chance of leaving a bequest of £50,000 or more. See: Cesira Urzi Brancati, Brian Beach, Ben Franklin and Matthew Jones. Understanding Retirement Journeys: Expectations versus Realities. International Longevity Centre - UK. 1 December 2015. p.41. Also, committing to a deferred annuity at-retirement, rather than secure a conventional annuity later in the retirement journey, obviates the cognitive decline and potential decision paralysis that typically advances with age.

37 This idea is expanded upon, albeit in an era of ultra-low yields, in: Generating Retirement Outcomes to be Enjoyed and not Endured. Chris Wagstaff. Columbia Threadneedle Investments. February 2018.

38 A 2009-10 Review which recommended a default retirement product that addressed among other factors, inflation and longevity risk, fell on deaf ears. This was revisited in 2013-14 with a recommendation for a comprehensive income product for retirement (CIPR) – combining a flexible but stable regular income stream with potential inflation and longevity protection. In 2017, the Australian Government passed a series of amendments to a number of regulations to enable life insurers and superannuation funds to "provide flexibility in the design of income stream products to meet consumer preferences while ensuring income is provided throughout retirement". See: Treasury Laws Amendment (2017 Measures No. 1) Regulations 2017.

index or actively managed fund - hence prospective income growth that should trump price inflation in the long-run - allied to the full or minimum return of remaining capital on death.[39]

Could variable annuities work in the UK? Possibly. Having been launched in the UK in 2005, variable annuities steadily gained traction until the fallout from the Global Financial Crisis in 2008 unseated the cost to insurers of providing a lifetime income guarantee. Although their reintroduction to the UK market was widely anticipated on the surprise announcement, in April 2014, of freedom of access to DC pots from age 55, instead full and partial cash withdrawals and income drawdown took centre stage and continue to do so.

The ongoing principal hurdles to the reintroduction of variable annuities remain the financial and regulatory costs pertaining to those institutions, principally insurers, that stand behind the solution. From a regulatory standpoint, UK insurers are heavily incentivised to write long-term life business that is, so-called, matching adjustment (MA) eligible[40] with the wedge in capital requirements between MA and non-MA business having a material impact on the insurer's return on capital. The ongoing withdrawal options and variable nature of their liability profile make variable annuities unlikely to be MA compatible.[41] Furthermore, the hedging of various guarantee features makes the ongoing management of variable annuities more complex and costly particularly during periods of extreme market volatility.

Therefore, if variable annuities are to emerge in the UK as a viable post-retirement option, there is work needed by insurers on product design to find that balance between marketability to consumers and ease of ongoing management. Likewise, regulators will need to play a role in creating the right incentives for insurers to offer a broad range of post-retirement solutions that offer genuine choice to consumers.

Another key consideration, this time from a consumer standpoint, is the potentially volatile income stream, given the solution's investment-linking, though this can, of course, be tempered by linking the variable annuity to a well-diversified multi-asset portfolio. A similar consideration applies to decumulation-only collective defined contribution.[42] Then there are significant encashment penalties if an emergency withdrawal is needed. Given these latter two considerations, variable annuities are best combined with a traditional level or escalating annuity, the latter acting as a guaranteed minimum income underpin, and drawdown for when additional funds are needed at relatively short notice.[43] This also reinforces the need for ongoing advice to deliver a holistic and flexible solution to retirees.

Why does this matter?

In a world of freedom and choice, the decumulation stage of the DC journey is fraught with difficulty. Currently, those at and in retirement, seeking flexibility and income security, through income drawdown, must successfully navigate myriad largely unquantifiable investment, economic and demographic risks. If not managed well, these risks can add up to an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings or living in penury in fear of the latter.

Indeed, the potentially dire consequences of making a wrong decision or decision paralysis, through lack of numeracy, financial literacy, relatable guidance and accessible advice, will continue to rise over time as DB pensions disappear, people start receiving their state pension ever later in life and increasingly become reliant on their DC pension pot to support their standard of living in retirement which, for many, might extend to 30-plus years.

If retirement is to be enjoyed and not endured, not least by an aspirational sandwich-generation, then the thought given by the pensions, asset management and adviser communities, with substantive input from regulators, to the design of what can be considered genuinely fit-for-purpose decumulation solutions, must be stepped up.

Indeed, whether a minimum, moderate or comfortable retirement in the UK becomes the norm, is largely contingent on timely and decisive action or continued inaction by both the pensions industry and policymakers. If policymakers, providers and practitioners can agree on appropriate defaults, a suite of simple, accessible and behaviourally robust guidance and low-cost advice more broadly, then it's reasonable to expect that this could unlock better investment strategies and culminate in better retirement outcomes. However, timely intervention is needed if the potentially significant, if not catastrophic, economic and societal risks that could result from continued inaction are to be avoided. In short, the clock is ticking.

39 See: Liquid Lifetime (Market-linked payments) | Challenger as an illustration of the key features offered by variable annuities in Australia.
40 The Matching Adjustment (MA) is a mechanism that allows insurance companies to recognise upfront, as capital resources, a proportion of the investment return that they are confident they will earn on the assets which are held against their long-term insurance liabilities. The MA provides a strong incentive for life insurance firms to closely match their asset and liability cash flows.
41 UK insurers that write annuities have created an asset origination model which seeks to maximise the matching adjustment spread by allocating to long-term illiquid assets. This enhances return on capital both by boosting returns and reducing capital requirements. However, the uncertain nature of the income profile of variable annuities makes the above a lot harder to achieve compared to conventional annuities.
42 See: 20231205-international-dc-decumulation-report-final.pdf (pensionspolicyinstitute.org.uk)
43 For a summary of the extent to which decumulation solutions meet consumer needs and wants, see: Identifying opportunities for innovation in post-retirement products - Paper 1.pdf (actuaries.org.uk) p.10.

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