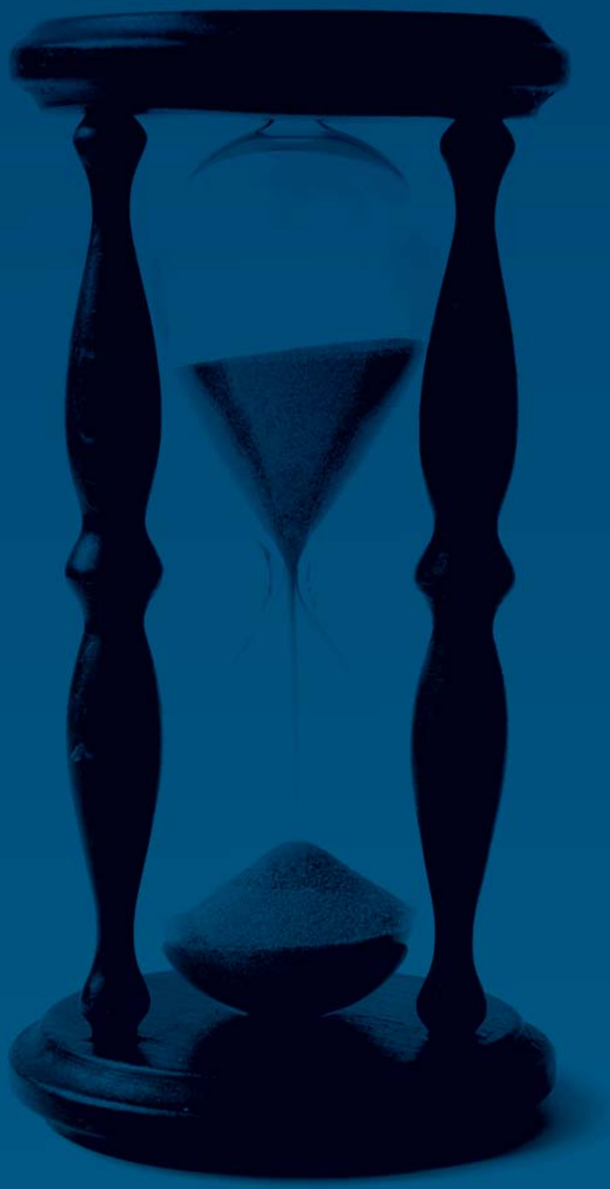
Association of
AIFA
Independent Financial Advisers

Financial Planning Through Retirement

Association of Independent Financial Advisers
in association with Prudential



Retirement has more potential with
PRUDENTIAL

Contents

1. Foreword

I had the real pleasure of visiting someone extraordinary in my constituency recently.

Martha (let us call her that) is 101. She lives in her own home, surrounded by her treasured possessions, with the devoted attention of three full-time carers. Of course, that type of care is expensive, so Martha has taken out an equity release mortgage on her valuable home to pay for it. The eventual repayments mean her son will inherit rather less when she does pass on, but it is a small price for seeing that she is properly cared for in her last years.

I draw three lessons from Martha and her living arrangements. The first is that ever-extending life expectancy really is an achievement of our society in which we should rejoice. Second is that, in an age when it is not realistic to expect the State to provide all the comforts we would like in retirement, individuals must proceed prudently to preserve the assets that they will need for that purpose. Third, we need the services of responsive and sympathetic financial advisers to make the most of those assets to secure the life we deserve in retirement.

People want a comfortable old age, to be able to take the opportunity to travel while health allows, develop new hobbies, and be able to afford to help out their children and give treats to their grandchildren. The old adage "not living too long, nor dying too soon" can take on tragic meaning if our financial affairs are not so organised to make these things possible.

For the financial services industry, this creates a real challenge. UK financial services have, in the main, been focused on helping individuals to accumulate wealth – and an important task that is too. But once that was done, few firms have much to offer.

In the past, many people could expect to benefit from defined benefit (DB) pensions, coming directly from the companies that they had worked for. They simply swapped a monthly pay cheque for a gold watch and a pension. Annuities were generally simple affairs, providing a set income from a set capital sum. So, apart from inheritance tax planning, there was not that much left for advisers to advise on.

That landscape is changing rapidly. The DB pension is becoming a thing of the past. Many people work for more than one company and have more than one pension pot. Annuities are not the complete answer they used to be. More and more people need to fall back on their other assets – an owner-occupied home being the main one – to provide a source of income today.

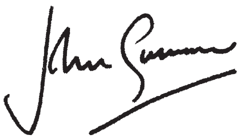
Most people are broadly aware of the need to save for retirement – even if far too many do not, either because they are unable to afford to do so or are too imprudent to choose to act on that knowledge. Few people are similarly aware of the need to plan once they have retired, to make the decisions necessary to make the most of what they have.

Older people need advice and help. Most are not expert on financial matters – and why should they be? Moreover, the issues involved are extremely complex. For example, there is a complicated relationship between personal assets and income and the benefits system, not to mention tax credits. Not only does this require expert attention, it requires attention from properly trained advisers, who are able to take a holistic view of the requirements of individuals and of their options for meeting them.

Good advice can help individuals, but it is not just individuals who need a joined-up approach. The necessary decisions take place within an environment populated by many different actors. Government decides the tax and benefits system. Regulators decide what rules apply to pension funds and set the terms with which financial services firms must comply. The financial services industry decides on what commercially viable products can be provided to meet the needs of their customers. Employers have responsibilities, even in the new era, to educate and explain. All these have to be put together in a holistic framework against the background of which individuals and their advisers will make the key decisions.

This report represents the first attempt to look at financial planning in retirement as a whole. It offers many pointers to the way ahead and to the issues that need to be dealt with. Most importantly it presents a challenge to our whole way of thinking about finance in retirement.

The process of preparing this report has been encouraging. Everyone, from advisers to product providers to the world of regulation and Government, has been eager to make a contribution. It has left us – the Association of Independent Financial Advisers – Prudential, the sponsors, and the Editorial Board (see page 11) confident that together we can work with all other parties to create a better world for retired people today and tomorrow.



Rt Hon. John Gummer MP
Independent Chairman
AIFA

“Good advice can help individuals, but it is not just individuals who need a joined-up approach”

2. Executive summary and summary of recommendations

The public has an ambivalent relationship with the subject of pensions and retirement. Most people look forward to the day when they finish work. On the other hand, many have little understanding of what they will live on after that day.

Couple this with a seemingly endless stream of facts and figures about an ageing workforce, population projections, average life expectancy, the cost of living and the welfare state, and it is little wonder that people switch off when it comes to this very important subject.

Between seven and nine million people are not saving enough for retirement. One stark fact is that in 2008 the median average defined contribution (DC) pension pot when converted into an annuity was about £15,000. In today's environment, this would generate a meagre income of around £920 a year[i].

But, we must move beyond the numbers to the critical issues facing people approaching or already in retirement, and consider how all the participants can work together to ensure that more people maximise their income and wealth in retirement – the "decumulation market".

First and foremost is the need for a realistic appraisal and understanding of how individuals actually manage their finances. For too long, Government and industry initiatives have been predicated on the belief that everyone has the time, interest and mental capacity to logically appraise their options and make considered financial decisions.

This simply is not the case. Long-term planning and future wellbeing are often sacrificed, or simply ignored, in favour of the short-term satisfaction of a holiday, a new car or dining out.

Many consumers are also overconfident that they are able to make the right decisions as they approach retirement.

Armed with this understanding, initiatives intended to improve retirement planning must help "nudge" consumers towards the right decisions; for example, with the use of auto-enrolment into pension schemes. While not abandoning efforts to improve financial capability, we need a new approach to financial services regulation and legislation grounded firmly in how consumers actually behave, rather than how we might like them to behave.

Equally, there is no "one size fits all" solution. Education and advice must cater for a wide range of consumers: from those largely reliant on the benefits system through to those with more complex needs who are considering investment, care and inheritance issues.

Talk of the annual £57 billion savings gap can serve to depersonalise the issue. In contrast, research that increasing numbers of people are saying that they wished they had saved more for retirement warrants further attention. Perhaps we can educate by example and exploit "herding instincts". People often act when they can see what has happened to others like them.

Furthermore, in terms of consumer education we believe that there needs to be an overall review of available information and of the way that information is communicated to the public – how, when and where – to ensure it reaches its intended audience.

One relatively simple measure that the industry can take is to work together to develop a glossary of terms in plain English that guarantees simplicity and clarity for consumers. Consumers will understand the risks and rewards of decumulation products better if they are described in consistent language. Part of this financial services language should be consistent illustrations of risk and reward applied broadly across different products. The good news here is that joined-up work is already underway in this area through various trade bodies.

More widely, it is a truism that individuals can only decumulate the assets they have accumulated during their working life. Long-term savings remain worryingly low, despite the fact that the State is unlikely to be in a position to make up for any shortfall in retirement. This puts the responsibility on individuals to ensure they have made adequate provision for their old age. The focus for Government, the regulators and the industry should be on helping individuals to plan appropriately for their retirement and make provision for their dependents. New initiatives that don't pass this simple test should be reviewed.

Another key trend is that more and more people will be forced to look at alternative assets to generate income in retirement. For those who have benefited from the significant growth in house prices over the past 20 years, equity release is increasingly a mainstream option. But, as outlined in our recommendations, Ministers must review the barriers to equity release to make it more attractive.

The changing decumulation market is creating a huge demand for guidance, information and advice. Responsibility for meeting this demand falls across a wide spectrum from Government through to employers who, with their unique relationship of trust with employees, are in a strong position to support the education of consumers.

Our primary research shows that, despite the decline of private sector DB pension schemes, employers will continue to be a key source of support to their former employees even after they have retired. To meet this growing demand, independent financial advice through the workplace should be better incentivised and promoted by the Government.

Discussions with industry practitioners have identified a risk that the FSA's Retail Distribution Review (RDR) will reduce the overall number of professional financial advisers. The potential shortage in overall adviser numbers, and specifically those qualified to advise on the decumulation market, is a major cause of concern for all.

The regulators should not introduce measures that restrict access to advice or set us on a path where professional financial advice unfairly becomes the preserve of the wealthy. On the flipside, the industry must ensure that it is ready to meet the demand. This includes providing access to advice, appropriate education and support services, as well as devising products to meet the specific needs of individuals.

Regarding macro policy and regulatory environment, we are concerned that rule-makers largely consider retirement as a single period without reflecting on how individual needs change throughout retirement. Research shows that the need for income is likely to be higher at the beginning and end of an individual's retirement, when care could become an issue, with a lull in the middle.

Unless increased co-ordinated action is taken in the next couple of years, the issues will magnify and we will simply see increased reactive regulation and legislation dealing with the visible symptoms of the problem rather than the root causes. The focus will continue to be on individual aspects of the in-retirement market, typically products, increasing fragmentation of regulation. The decumulation market must be viewed holistically.

The Editorial Board's specific recommendations are set out in the following pages, presenting challenges for all parties involved in "Financial Planning through Retirement". While all are important, the areas presenting the greatest concern in the short term are:

- The need for Government and the regulators to ensure financial education initiatives make consumers aware of their personal "ownership" of securing their financial well-being in retirement: information must be pitched at a level that is appropriate for the differing sectors of the population and take account of behavioural economic factors.
- Recognition of the decumulation market as an important and vital market in its own right. It is essential that Government departments and the regulators have a common objective and approach, and we believe an independent review should be commissioned by Government to achieve this aim.
- Clear guidance should be given to all those who provide advice and guidance to consumers about what decumulation is, how the dynamics work, and what the implications are for them, the markets and the consumers they serve. This will enable consumers, wherever they have contact with the financial services industry, to receive consistent information in a suitable language.

Summary of Recommendations:

Consumers:

- Regulation and legislation should be based on how consumers behave rather than how perfectly rational consumers would behave
- There should be a review of financial capability programmes to ensure they are improving financial education levels as cost-effectively as possible

Employers:

- Independent financial advice in the workplace should be better promoted and funded by the Government and employers

Advisers:

- Clear guidance and training is needed for those who provide decumulation advice

Product providers:

- There is a need to continue to develop and improve products which have a broad band of suitability that can be understood by the consumer
- Product providers should adopt a consistent approach to product features, product suitability, product comparisons, and risk and return. An industry standard glossary of terms should be agreed

Legislation and regulation:

- Equity release regulation should be amended to allow greater consumer access to advice on equity release
- The level of capital disregarded for retirement means-tested benefits should be reviewed on a regular basis to ensure the rules do not penalise equity release
- The Government should establish an independent review of the rules requiring pension income to be secured by age 75 to ensure they appropriately balance the needs of retirees with the interests of taxpayers
- Two critical success measures for the RDR should be the extent to which it increases the availability of advice and guidance, and the extent to which it raises the level of consumer engagement with financial services
- We recommend the Government commissions an independent review aiming to deliver institutional arrangements that ensure a joined-up regulatory and public policy approach to decumulation

3. Detailed recommendations

1. Consumers

a. Regulation and legislation should be based on how consumers behave rather than how perfectly rational consumers would behave

i. Retirement legislation and regulation needs to reflect the behavioural patterns and limitations of consumers, rather than a false concept that consumers are always rational.

b. There should be a review of financial capability programmes to ensure they are improving financial education levels as cost-effectively as possible

i. The Editorial Board applauds the wide-ranging nature of existing programmes e.g. the FSA-led National Strategy for Financial Capability. However, our consumer research shows that the reach of these programmes is limited. The work commissioned by the FSA from the London School of Economics[ii] looking at financial capability and consumer behaviour came to a similar conclusion. Government should conduct a thorough review of all existing communication programmes from across the industry to understand what is currently available, the level of use and its effectiveness.

The FSA's Consumer Responsibility Discussion Paper published in December 2008 underscores the importance of individuals understanding their "ownership" of decisions. The Government needs to build on this and, taking into account consumer behaviour (see above), improve the effectiveness of communication to consumers, outlining the decisions they must make about savings levels, investments and retirement choices.

ii. Education programmes for consumers should be available, at appropriate levels, throughout people's lives. This will encourage individuals to plan and provide for their retirement, based on a clear understanding of the benefits of doing so.

There will be increased consumer education surrounding the introduction of Personal Accounts, but the way that information is communicated is crucial. The Personal Accounts Delivery Authority (PADA) must ensure that the language used, the frequency and timing of communications are adequate to educate their target audience.

2. Employers

a. Independent financial advice in the workplace should be better promoted and funded by the Government and employers

i. Employers are a trusted source of information for individuals and have an important role in education. The existing £150 per annum tax exemption for funding independent advice to employees is not well known and should be promoted more widely.

However, the amount of this benefit needs to be reviewed as it is possible that it sends a misleading message to employees that £150 is a sufficient and reasonable amount to pay for financial advice.

ii. There is a need for guidance to provide greater clarity for employers, providers and advisers on their respective responsibilities in providing workplace-based advice on retirement products.

3. **Advisers**
   a. **Clear guidance and training is needed for those who provide decumulation advice**
      i. All parties who provide advice to consumers on managing income and wealth in retirement need clear guidance. This will enable consumers, wherever they touch the financial services industry, to receive consistent information in suitable language.

         Guidance for advisers should include practice notes that cover processes; the need for, frequency and content of client reviews; and product suitability.

      ii. Advisory firms should ensure that decumulation-focused training is available for advisers, and advisers themselves should ensure they have the appropriate skills and knowledge.

4. **Product providers**
   a. **There is a need to continue to develop and improve products which have a broad band of suitability that can be understood by the consumer**
      i. There appears to be a need for products, and for appropriate advice and guidance, suitable for the mass market. These should be tailored for distribution through all channels, including through a simplified process such as guided sales.

         Such products should be designed as appropriate default products with little or no likelihood of future regulatory challenge. It should be simple for the individual to understand how the key benefits of these products will meet their stated needs.

   b. **Product providers should adopt a consistent approach to product features, product suitability, product comparisons, and risk and rewards. An industry standard glossary of terms should be agreed**
      i. To help consumers to come to grips with planning for retirement, providers must adopt a consistent approach to the way that products are described in terms of risk and return, comparisons with other products and suitability. A glossary of terms for use across the industry should be agreed.

         Providers have their own communication strategies for advisers and consumers. This has to be encouraged since the nature of the UK market is to encourage competition and innovation. However, consumers often face multiple definitions of the same term/concept because of these differing communications strategies. There needs to be a consistent approach from providers in the way they communicate to consumers in terms of:

         (1) Language (definitions and simplicity of expression)

         (2) Explanations of risks and benefits

         (3) Who it might suit and who it would not be suitable for

      ii. The industry needs to develop a glossary of terms in plain English for universal use to guarantee simplicity and clarity for consumers.

      iii. The purpose of a universal language for the market is:

         (1) To allow objective and factual comparison. For example, a conventional annuity offers an absolute guarantee that the payment

will continue throughout the individual's lifetime, while income drawdown is reliant upon the performance of the underlying investments.

(2) To specify whom the product is suitable for.

5. Legislation and regulation:

a. **Equity release regulation should be amended to allow greater consumer access to advice on equity release**

i. We recommend that the rules governing equity release are amended to allow greater consumer access to advice on equity release. For example, equity release falls under the Mortgage Conduct of Business (MCOB) rules and should remain so in order that those offering advice can continue. However, there should also be alternative regulation for equity release under Conduct of Business (COBS) rules to allow advisers operating under these rules to advise on these propositions – in the same way that protection products fall under Insurance Conduct of Business (ICOBS) and COBS.

As MCOB is under review, we suggest that the above considerations could be a part of the review in progress.

b. **The level of capital disregarded for retirement means-tested benefits should be reviewed on a regular basis to ensure the rules do not penalise equity release**

i. The overall approach to any changes in regulation or legislation must ensure that it is appropriate, in terms of benefit entitlement, for someone to save.

ii. The 2009 Budget created a greater buffer for people who utilise the equity in their home as a source of additional income by increasing the means-tested threshold to £10,000 from £6,000. We commend this and recommend that the level of non-means tested capital is reviewed on a regular basis so that equity release continues to be an appropriate course of action.

iii. We recommend that Ministers re-examine obstacles to equity release so that there are fewer disincentives for consumers. Widespread home ownership and the existing pension gap mean that equity release will become an increasingly important way for individuals to provide for their retirement.

c. **The Government should establish an independent review of the rules requiring pension income to be secured by age 75 to ensure they appropriately balance the needs of retirees with the interests of taxpayers**

> “An industry standard glossary of terms should be agreed”

i. We recommend that the age 75 rules are independently reviewed and updated by a group appointed by government under a strong and knowledgeable chairperson. The age 75 rules are based on historical facts about life expectancy. While these rules are only an issue for a small number of consumers wealthy enough to delay annuitisation, the world has changed. People are living longer, so it is appropriate that the rules should reflect the current reality.

ii. The focus should be on giving individuals the ability to plan appropriately for their retirement and make provision for their dependants.

iii. It should be possible to purchase a capital-protected pension annuity that allows lump-sum benefits on death beyond the age of 75 (with appropriate tax treatment of the funds after death); that is, no age limit on value protection with a tiered tax charge to discourage the use of a pension scheme as an inheritance tax avoidance.

d. Two critical success measures for the RDR should be the extent to which it increases the availability of advice and guidance, and the extent to which it raises the level of consumer engagement with financial services

i. Because there are growing numbers of consumers needing advice, any changes to regulations should aim, at the very least, to retain current adviser numbers in the industry and to encourage new entrants into the profession.

ii. The FSA's Retail Distribution Review should seek to ensure that every individual has a number of options in terms of where they can seek information, guidance and advice.

iii. In order to demonstrate to consumers the cost of the regulatory overheads, we recommend that, when advisers and consumers agree fees, there should be an indication of the amount that covers regulatory costs.

e. We recommend the Government commissions an independent review aiming to deliver institutional arrangements that ensure a joined-up regulatory and public policy approach to decumulation

i. There are multiple departments and organisations involved in setting and monitoring rules and regulations for the decumulation market. This results in an inconsistent approach to a market of growing importance. It is imperative that an integrated and holistic approach is developed. Government departments and the regulators need to have common objectives, with a common approach to the decumulation market.

We recommend the Government commissions an independent review to deliver this vision. We also recommend that the research and analysis contained in this paper be used as key input for this review.

A key benefit of a holistic and integrated approach to decumulation would be better representation of UK interests with appropriate European bodies.

4. Sources of information

We commissioned a number of bespoke research initiatives to ensure that this paper reflected up-to-date thinking on the major issues concerning the various participants in the at-retirement market: public policy practitioners and experts, regulators, legislators, product providers, consumer groups, trade organisations and advisory firms.

We would like to thank everyone who contributed their time for their valuable inputs and insights. A full list of participating organisations is attached (see Appendix A).

In addition to interviews and meetings with the above, we commissioned primary research with consumers. Ipsos MORI interviewed more than 1,000 people to find out where they would seek information about their retirement options or, if they had retired, where they had gone for information.

Analysis of these responses has been fundamental to this paper, which seeks to:

- Review the retirement and advice landscape in the UK;
- Analyse consumer needs at and in retirement, now and in the future, and assess whether the solutions provided by the industry can be enhanced;
- Propose solutions where there are identified gaps between consumer need and industry provision.

The research and preparation of this paper was overseen by an Editorial Board comprising:

- The Rt Hon. John Gummer MP
- Lord Lipsey of Tooting Bec
- Professor David Blake, Director of the Pensions Institute, Cass Business School.
- Allan Rosengren, Joint Chief Executive, Lighthouse Group
- Mark Lund, Chief Executive Officer, Money Portal
- Chris Cummings, Director General, AIFA
- Barry O'Dwyer, Managing Director, Retail Life and Pensions, Prudential UK
- Tom Boardman, Director, Retirement Strategy and Innovation, Prudential UK
- Russell Warwick, Distribution Strategy Director, Prudential UK

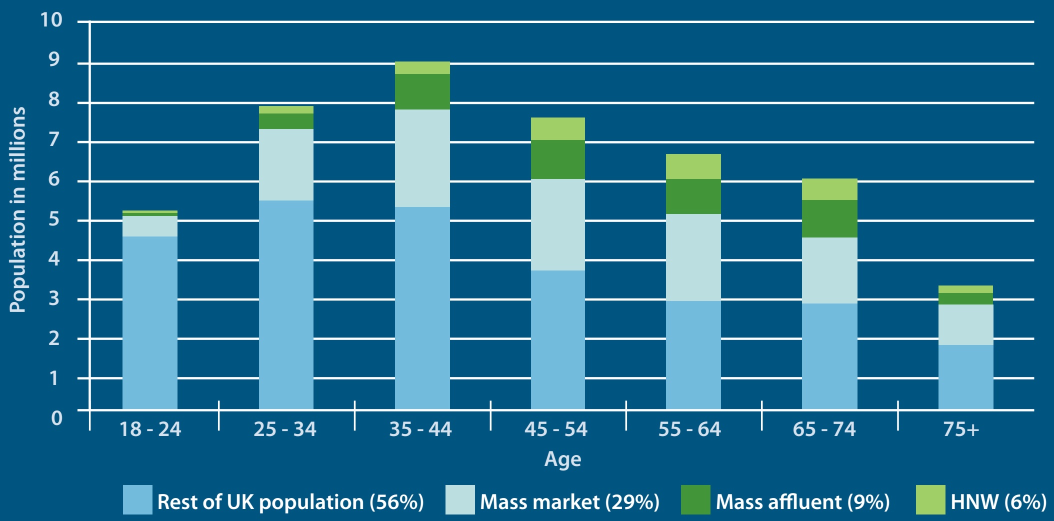
Research to support the study was conducted by a team of specialist financial services consultants from Watson Wyatt.

5. Income and Wealth Landscape

The retirement-age population increased from 10 million people in 1981 to 11.6 million people in 2007. The number of people of State Pensionable Age is expected to increase to about 15 million by 2031. Watson Wyatt predicts that the UK at-retirement market for financial products will more than double by 2012 to more than £30 billion a year, from £13.6 billion in 2007[iii]. This is a substantial market that will continue to expand as more individuals need to convert pension savings and other investments into income.

As a segment, those at or near retirement own a significant proportion of the overall wealth in the population. According to research conducted by Deloittes (chart 1) in the age groups over 55 in particular, there are significantly higher proportions of high net worth (with liquid assets of £100,000 or more or with an individual salary of £75,000 or more) and mass affluent (with liquid assets between £50,000 and £100,000 or an individual income between £40,000 and £75,000) consumers than in the population as a whole.

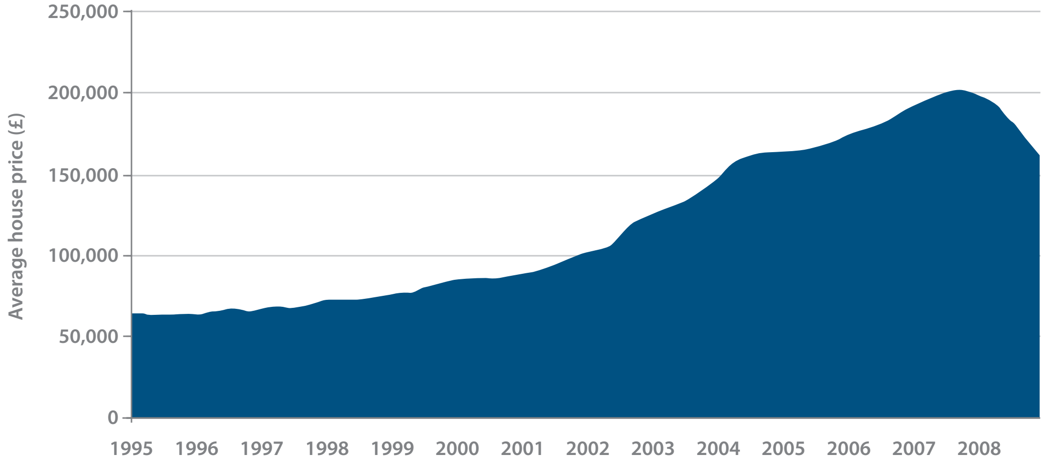
Chart 1: UK population by age and wealth segment



Source: Deloittes' Wealth and Portfolio Choice 2007 Survey

A significant driver of these higher wealth levels in the older age groups has been the growth in property values over the past 20 years. The Halifax House Price Index (chart 2) shows that the value of the average UK home increased in nominal terms from £61,666 to £179,182 from 1995 to 2008, adding significantly to the accumulated wealth of the older generations.

Chart 2: UK standardised average house prices (seasonally adjusted) 1995-2008



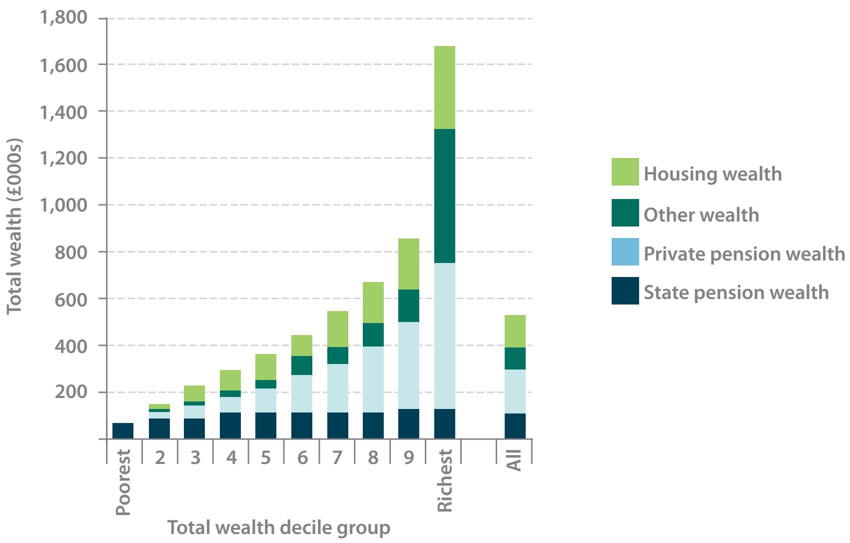
Source: UK Standardised Average House Prices (seasonally adjusted) 1995-2008, Halifax (2009)

While the overall wealth of the population in or near retirement compares favourably with the population as a whole, that wealth is not evenly distributed. There are significant differences within this group driven by a variety of factors, such as the geographical differences in house price growth. It should also be remembered that not all of this group entered, or were financially able to participate in, the property market (or purchased property sufficiently long ago to benefit from significant increases in property value). Consequently, 20% of the population aged 50 and over have no housing equity.

This uneven distribution of wealth is highlighted further by the distribution of other asset holdings within the older population (chart 3). Within the wealthier segments, property wealth is clearly higher, as would be expected, but a significant feature is the distribution of liquid assets in the form of private pension wealth and other assets. The majority of liquid assets in these forms belong to the wealthiest 30% of the population whereas housing wealth becomes the dominant feature further down the wealth ladder.

“a significant feature is the distribution of liquid assets in the form of private pension wealth”

Chart 3: Mean level of each type of wealth by decile of total wealth



Source: "Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England (2005)" Institute For Fiscal Studies. Based on a sample of 4,687 individuals aged between 50 and the State Pension Age.

A significant factor in the income and wealth landscape of those in or near retirement is that many of them have income from a DB pension scheme accumulated during their working life.

Recent analysis by the Pensions Regulator (TPR) shows that, of the 12.4 million consumers with some form of private sector DB arrangement, 4.43 million are drawing their pension.

The switch from DB schemes to DC schemes over the past 20 years will have a significant effect on the retirement income of future generations. According to TPR in its Purple Book 2008, the estimated number of DB schemes[iv] was about 7,400, down from roughly 7,500 in 2007 and 7,800 in 2006. The move away from DB schemes will be felt gradually over the next 20 years as there are still about 2.74 million individuals in active private sector DB schemes and another 5.23 million with deferred benefits.

While the focus of this study is the decumulation stage, we must consider the accumulation stage of an individual's life because this is when they begin the journey towards asset decumulation. Decisions made at this time, and the available options, are crucial.

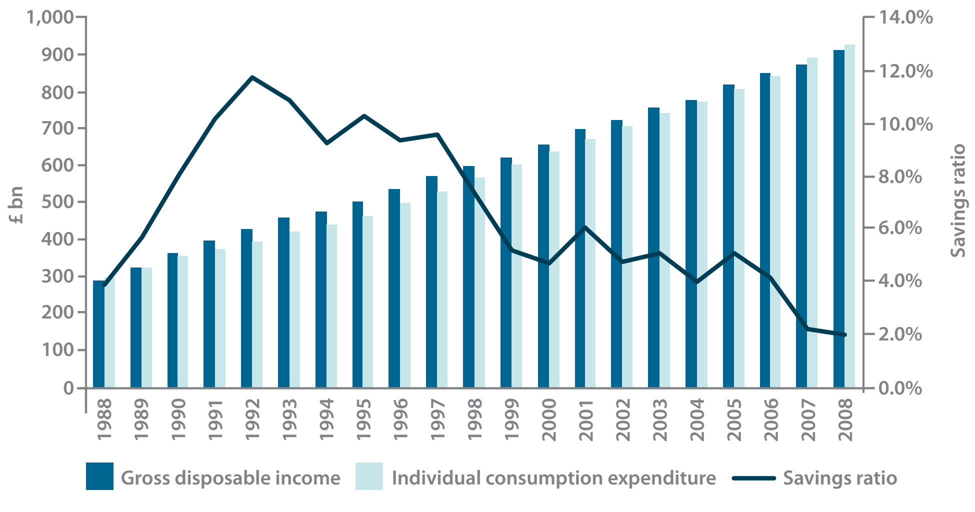
The most significant issue in the UK accumulation market is the trend towards falling savings ratios. The past 15 years have seen a significant drop from a peak of nearly 12% to a little more than 2% at the end of 2008. As of today this has increased to 5%, although much of this increase is attributable to hoarding during an economic downturn rather than medium-to-long-term saving, and might be expected to shift into consumer spending as consumer confidence improves.

Over the same period, individual consumption expenditure increased to the extent that it overtook gross disposable income, leading to the significant levels of consumer debt that we see today (chart 4). In line with savings, this trend has reversed over the past 6 months with consumers repaying debt.

Alongside this, it is uncertain that the house price growth of the past 20 years will be repeated.

This pattern clearly leaves significant concerns for the income provision of future generations.

Chart 4: UK Individual disposable income, consumption and savings ratio, 1988-2008



Source: Office for National Statistics (April 2009)

On further analysis of this pattern, research by the Department for Work and Pensions (DWP) estimates that about 7 million people are not saving enough to deliver the pension income they are likely to want, or expect, in retirement. The Association of British Insurers (ABI) estimates suggest that 9.6 million people are not saving at all for a pension[v] and are likely to be entirely dependent on State benefits or other accumulated assets for income in retirement.

The main message is clear: whichever way the information is dissected, people are not making sufficient provision for their retirement.

When analysing the reasons behind the low level of savings, it becomes clear that individuals place a relatively low priority on saving for retirement. The Watson Wyatt Pensions Research Forum[vi] shows that debt repayments, housing and the general cost of living are the top three financial priorities for employees under the age of 50. For those between 50 and 60, saving for retirement increases in importance, but it is still rated behind debt and housing.

This low priority towards retirement saving contrasts with responses from those who have already reached retirement. ABI research, due to be published shortly, shows many people in retirement wished they had saved more while they were working.

The most significant feature on the savings landscape is the introduction of Personal Accounts and compulsory auto-enrolment in 2012. The Government and the Personal Accounts Delivery Authority (PADA) believe that the scheme will complement existing workplace pension arrangements, increase the number of people aware of the need to make their own pension provision and increase the number of people actually saving for retirement. In the longer term, Personal Accounts and compulsory auto-enrolment have the potential to have a significant effect on income in retirement, but are unlikely to have a significant effect in the short term.

Chart 5: Future replacement income ratio for different earnings levels

Source: Watson Wyatt (April 2009). Numbers based on a single life, starting at age 25 through to a retirement age of 65. Initial incomes are £10,000, £20,000 and £30,000 rising to £12,000, £44,000 and £118,000 respectively. The contribution level is 8%, based on earnings between £5,300 and £35,500. The mean investment return is assumed to be 4%, net of charges.

In the first report of the Pension Commission, it estimated that the gap between how much people were saving and how much they needed to save to ensure a comfortable retirement, on an annual basis, was more than £57 billion.[vii] With the subsequent drop in financial markets, this figure is likely to have increased significantly. This is demonstrated by the average size of pension funds: 2008 ABI statistics indicate that 88% of the pension annuities sold that year were for less than £50,000; 63% were below £20,000. However, with more than 5 million people holding deferred private sector DB pensions, it is clear a significant number of people will hold a mix of DB and DC pensions when they retire.

With pension reform moving the State Second Pension to a flat rate basis and including credits for carers and those on low incomes, future replacement rates for such individuals across the Basic State Pension (BSP), State Second Pension (SSP) and Personal Accounts appear to ensure that this segment maintains their level of income in retirement (chart 5).

Decumulation market issues discussed later in this paper are exacerbated by current accumulation issues; if people don't have sufficient savings as they approach increasingly lengthy retirements then they will have to rely heavily on the State – not the desired outcome for any of the market participants nor, indeed, sustainable given the demographic reality of an ageing population and low birth rate. Any actions suggested to address decumulation market issues will not address accumulation issues, nor should they be expected to. However, it is essential that any suggested actions are consistent to ensure that a cohesive and co-ordinated approach is adopted, resulting in the best possible outcome for the consumer (as "pensioner" and "taxpayer").

6. The need for guidance and advice

We interviewed people from all sectors of the "at-retirement market", such as consumer groups, trade associations and product providers, for this paper. Irrespective of who was consulted and which element of the market they represented, there was a clear, consistent message: people approaching retirement, and those who have already retired, need access to suitable information, guidance and advice.

The income and wealth landscape set out in the previous section demonstrates significant differences in the financial profiles of consumers. These, in turn, require different solutions to fulfil different needs, taking account of the complexity of individuals' needs and the financial practicalities of ensuring that the benefit is not outweighed by the cost of providing it.

We can split the population as a whole into a small number of segments, each with specific needs.

Segment 1: Low-income, state-dependent

This segment is defined as individuals with less than £10,000 liquid assets or an individual income of less than £20,000.

People in this segment are likely to have been in the State benefits system for some or all of their working life with, typically, no pension provision because they have not, for a variety of reasons, consistently held a job.

For this group, the most likely source of information and guidance will be the Government and its various representative bodies. These sources are familiar to the individuals and therefore trusted to provide accurate and appropriate information and guidance on how the individual can claim the necessary State benefits to ensure a minimum level of income in retirement.

In addition, this group may use sources such as the Citizens Advice Bureau and charities such as Help the Aged and Age Concern.

A full Basic State Pension provides £95.25 a week (in 2009/10) and is currently up-rated by the greater of RPI or 2.5%. In 2007/2008, 85% of men and about a third of women reaching State Pension Age received a full Basic State Pension.[viii]

The Pensions Act 2007 made significant changes to the State pension system, increasing the spread and generosity of the BSP and curtailing future income-related State Second Pension for moderate and high earners. These reforms will lead to more than 90% of men and women receiving a full BSP by 2025.[ix] The key reforms reduce the number of qualifying years to 30 and expand crediting activities to include those who care for a person with a disability for more than 20 hours a week.

In addition, the value of the BSP will be enhanced by earnings up-rating. The result is that the BSP is expected to approximately double in value by 2050 compared with what it would have been under pre-reform up-rating policies. It also ensures that the BSP remains around 75% of the guarantee credit level, with most people receiving SSP in addition.

In terms of other benefits:

- About 3.3 million people currently benefit from support through Pension Credit[x]
- About 1.5 million pensioner households get help with their rent through Housing Benefit. Approximately 1 million of these also receive support through the guarantee element of pension credit[xi]
- Approximately 2.5 million pensioner households receive help with their council tax bills[x]

This consumer segment is likely to make limited use of the life and pensions industry, either at or during retirement, with use largely restricted to relatively small annuities and some savings products.

Segment 2: Mass market

Mass market is defined as individuals with £10,000 to £50,000 liquid assets or an individual income of £20,000 to £39,000.

This group represents a significant proportion of the working population on low to middle-income levels.

For this segment, the move towards flattening the SSP is likely to reduce an individual's overall State Pension entitlement. As a result, the introduction of Personal Accounts and compulsory auto-enrolment has the potential to have a significant impact on their savings for retirement. It is aimed at providing an additional pension savings vehicle for the 7 million individuals (PADA estimate) who aren't saving enough for retirement.

The proposed Personal Accounts process for converting savings into income will be automated using the internet as the main channel. Individuals will be guided through the process via information on web pages. In most cases, this will lead to individuals taking an annuity or a trivial commutation. In the ABI's response to PADA's consultation paper, it highlights that:

"Many people find retirement income choices and the process itself difficult to understand, and for this reason support and guidance should be offered to members to assist them in making the correct choice. This is particularly important for members for whom choice has been "designed-out" (i.e. by auto-enrolment, default fund, default contribution rate) at all earlier stages of the process."

Employers provide a cost-effective channel through which financial services can be distributed to the mass market. Workplace advice and guidance is an opportunity to reach employees who may not have access to, or knowledge of, alternative advice channels.

There is an expectation that the demand for annuity advice will grow in line with increasing DC pension provision. The FSA's work on money guidance and guided sales model (Retail Distribution Review) is aimed primarily at increasing the support available to the mass market on a cost-effective basis.

Access to a form of guided sales model may well be sufficient for the needs of many as they annuitise. However, this segment of the market may also need to consider alternative means of securing an income during retirement, such as equity release, or they may have to consider the need to pay for care services. Money guidance or guided sales are unlikely to be a suitable answer in many instances of complex needs.

However, for many within this group there is a considerable need for a small number of well-designed and tested products with a wide suitability range that can be delivered via simple guidance. In many cases, the use of decision trees can facilitate this process or highlight situations where more complex advice requirements exist.

Segment 3: Mass affluent

Individuals with £50,000 to £100,000 liquid assets or an individual income of £40,000 to £75,000 are defined as the mass affluent.

Employer-sponsored and private pensions are an important source of income in retirement for the majority of employees within this group. According to Watson Wyatt research[vi], 68% of respondents rated these sources as either very or extremely important. However, property (49%) and non-pension savings (53%) are also given considerable importance by many as expected sources of income in retirement.

Typically, individuals in this segment will have a variety of sources of possible income in retirement and utilise a variety of investment vehicles. In an ABI study[v], respondents were asked how they were personally saving or investing for their retirement:

- 23% had a cash ISA
- 22% had a personal pension
- 19% had a savings account
- 19% had property

An additional complexity within this group is the accumulation of different pension pots from different periods of employment. AEGON research into pension savings showed 34% of individuals surveyed had one fund, 22% had savings in two pensions and 9% had three or more pension pots.

Throughout our research with market participants, the complexity of this segment's requirements was highlighted, as was the view that such individuals should seek out suitable forms of guidance and advice to help to optimise the generation of income throughout their retirement.

According to the ABI[v], there are 1.4 million non-savers (15%) with an annual income of £30,000 or more. For these higher-income people, the decision to save should be relatively straightforward because they are less likely to be entitled to means-tested benefits, which can act as a disincentive to save, and many of them would be entitled to higher-rate tax relief on any pension contributions.

After retirement, people in this segment are more likely to hold sufficient assets to sustain ongoing investment risk and to pay for the necessary advice. As such, a wide variety of products, such as unit-linked and with-profit annuities, as well as variable annuities[v], may be of interest. Many individuals within this segment are willing to seek independent advice; however, some will rely upon their local bank or building society as their main source of information, guidance and advice. This segment may also be well served by employers and the provision of services within the workplace.

With their more complex sources of income and savings above the minimum set by the Government for State benefits, individuals in this segment are likely to have to self-fund care provision, using the variety of assets they own, including their home in many cases. Therefore, products such as equity release and, depending upon the outcome of the Government's Green Paper on care, long-term care products are possible needs.

Segment 4: High net worth

Individuals with £100,000 or more liquid assets or an individual income over £75,000 are defined as high net worth.

This segment of the market, as for the mass affluent, has multiple sources of possible income in retirement. Individuals are more likely to have sizeable pension funds, which leads them to consider products such as income drawdown and variable annuities. They are aware of the potential benefit of maintaining exposure to the investment market into their retirement and hold sufficient levels of assets to make the cost of advice economically effective.

This segment is most likely to seek information and advice from an independent financial adviser, and many will do so after their own initial research. The need for ongoing advice throughout retirement is most apparent for these individuals, to ensure that they optimise the different assets available to them in the most tax-efficient manner, including inheritance planning for their estate.

It should also be remembered that, for a reasonable proportion of this sector, wealth accumulation will continue into retirement as returns on assets and sources of income outstrip their spending requirements. Therefore, inheritance planning becomes as important as managing income requirements.

“This segment of the market, as for the mass affluent, has multiple sources of possible income in retirement”

7. The consumers' perspective

P. 22
Consumers are uninterested in financial services

a. Consumers are uninterested in financial services

"Consumer expectations are difficult to manage. People do not understand how much money they are likely to need to ensure a good standard of living in retirement. They do not understand just how much it takes to buy an income. They think they have saved a few thousand pounds and that should be OK. They do not understand longevity risk and the need to generate income in the right way. A lot of people are still going into retirement with outstanding debts. They do not understand the impact this has on their finances."

[Source : Advisory Firm][xii]

A key question is whether individuals are aware that they are responsible for their decisions when they approach retirement and, if so, whether they are suitably equipped to make informed choices? The ability to make informed choices would generally require a person to understand a myriad of issues and their implications, but the typical person is unlikely to have this knowledge as they are generally uninterested in such topics. Research conducted on behalf of PADA[xiii] concluded that:

"Most respondents' awareness and understanding of pensions and annuities was patchy, low or virtually non-existent. This was true even among those who were fairly confident and capable with finances in general."

Underlying much of consumers' disinterest in financial services is a general trend towards cynicism and distrust which appears to have become more prominent in recent times. This trend has been confirmed by research from the Financial Services Consumer Panel (FSCP), which commented: "Consumer trust in traditional institutions is in decline, as consumers lose their traditional deference to authority." [xiv]

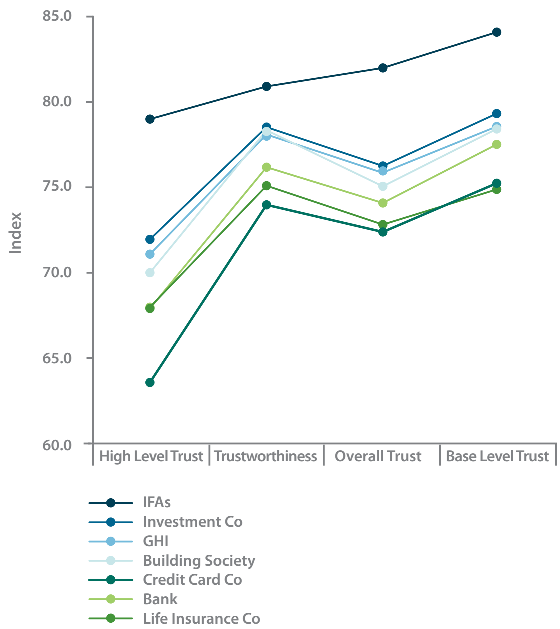
The Consumer Panel also found there was a further trend towards cynicism and distrust "specifically within financial services". The panel said the perceived "profit rather than customer" focus of financial services providers was driving an increasing distrust. This has been further exacerbated by recent experiences and media exposés of credit card and overdraft charges; coverage of problems with UK banks; historical issues such as pension fund failures [26 company schemes transferred to the Pension Protection Fund (PPF) in March 2009 alone, covering over 8,800 members[xv]]; the pensions mis-selling of the 1990s[xvi]; the highly publicised issues around Equitable Life; and Robert Maxwell raiding his company's pension fund.

It should be remembered that, in many of these situations, there is a difference between perception and reality. The negative effect that these events have on consumer confidence is often disproportionately large compared with the scale of the event being reported.

Many of the conclusions from the Financial Services Consumer Panel are supported by the findings of the Financial Services Trust Index, developed at Nottingham Business School on behalf of the Financial Services Research Forum to monitor levels of consumer trust in the industry[xvii]. The findings of the Trust Index indicated, for example, that many financial services companies got their highest customer ratings in relation to reliability and competence in their field; that is, in the area of low-level trust. But they found it much harder to present themselves to customers in terms of higher-level trust, particularly in relation to shared values. In other words, while many customers trust their insurance company to operate efficiently in its sector, fewer felt that it had their interests at heart.

Another challenge for financial services companies is the channel of interaction with consumers. Data from the Financial Services Trust Index shows evidence of a decline in trust among users of internet channels and also shows that face-to-face relationships evoke greater trust than remote distribution. Face-to-face contact, with its individualised approach, underpins the relationship typified by financial advisers and most notably IFAs. It also suggests that other financial services organisations may need to pay particular attention to the extent to which service delivery is depersonalised. The Trust Index shows that IFAs are the most trusted financial services companies in terms of base-level trust, high-level trust, as well as overall trust (chart 6).

Chart 6: Trust by Institution



Source: The Financial Services Trust Index 2009, University of Nottingham

In the Ipsos MORI research conducted as a key part of the development of this paper, 1,205 individuals aged over 40 answered questions on their levels of knowledge and confidence about decisions that they must make around converting their accumulated pension funds into an income for retirement. Of those within five years of full retirement, a significant minority of 40% of respondents were not fully aware of the financial decisions they needed to make at retirement with similar findings for the group that had fully retired within the past five years (44%).

The FSA's "Establishing a Baseline" survey of financial capability in March 2006 highlighted the lack of consumers' financial awareness and low capability. It concluded that nearly half the UK population was either making insufficient effort or was incapable of planning ahead (although, importantly, older groups scored significantly better than younger age groups). It also concluded that in choosing financial products, consumers did remarkably little shopping around to ensure they got a good deal and that while 74% of those surveyed had bought some form of financial product in the last 5 years many of them had chosen poorly.

Therefore, it is clear that, despite the multitude of websites, telephone help-lines and other sources of information, the levels of engagement and awareness of individual's financial responsibility remain in need of attention.

This remains the core challenge for Government and the industry into the future.

b. Consumers are not always rational

An emerging theme in consumer education, as highlighted by the FSA's "Consumer Responsibility" paper in December 2008, is the importance of behavioural economics.

Behavioural economics is primarily concerned with understanding the cognitive and emotional factors that influence a consumer's economic decision making and behaviour.

Within this field, consumers have been divided by Richard Thaler and Cass Sunstein in "Nudge: Improving Decisions about Health, Wealth and Happiness" (Richard Thaler and Cass Sunstein, published by Yale University Press in 2008) into two types:

- "Econs" are highly rational consumers who fully understand the complex set of choices they are faced with and have the skills to make decisions that will improve their welfare and happiness. Thaler and Sunstein believe that very few people are "Econs".
- "Humans", by contrast, try to plan ahead and intend to make the best decisions for themselves, but they are subject to behavioural traits that limit their ability to implement their plans. This is particularly true when it comes to implementing long-term plans, such as saving for retirement and planning spending through retirement.

"Humans" understand the value of a good pension in retirement, and might even plan to join a pension scheme one day. But many "Humans" are subject to a behavioural trait called inertia, which means that they never actually get around to joining a pension scheme. Many of those who do join a pension scheme are subject to another behavioural trait: lack of will power. They soon find a good reason to stop contributing, such as the desire to go on a foreign holiday. They might plan to rejoin the pension scheme after the holiday has been paid off, but many fail to do so.

When it comes to planning their finances through retirement, "Humans" have an aversion to large long-term transactions such as converting their pension savings into an annuity, as well as facing reality when they have inadequate savings. "Humans" tend to over estimate the probability of low-probability events such as early death and underestimate the probability of high-probability events such as living beyond their life expectancy (by definition half of pensioners will live beyond their life expectancy). They also tend to overvalue the present and undervalue the future. All this leads to over confidence and self-control problems leading to "Humans" having a tendency to over-consume today and so face the possibility of running out of retirement assets before they die.

A potential solution for dealing with "Humans" and their behavioural hurdles is to "nudge" them towards making decisions that improve their welfare with methods such as auto-enrolment into a pension scheme. In this case, inertia prevents most people opting out and this seemingly negative trait is used constructively to improve welfare. The requirement to "secure" income with pension savings by age has helped to overcome inertia and procrastination.

The existence of two types of individuals should have an important bearing on the nature and value of financial advice offered to consumers and the level of education that consumers need or desire. It should also influence the type of products offered and the regulatory framework within which IFAs and product providers operate.

> "Humans" understand the value of a good pension in retirement

P. 25
Consumers are not always rational

- "Econs" are able to make an optimal trade-off between the level of education they invest in (allowing for the financial and time costs of this) and the level of advice they pay for (e.g. for specialist tax advice). The more that "Econs" educate themselves, the less advice they need. The less they educate themselves, the more advice they need and are willing to pay for. They can rationally determine the optimal mix of education and advice.
- "Humans" will benefit from some basic financial education that emphasises, for example, the importance of saving enough for retirement and the need for advice, but they will not be interested in anything more sophisticated than this. They will expect and want advisers to suggest the best solution for their circumstances and needs.

Some of the messages that are beginning to emerge from the behavioural economists are likely to have a profound impact on the way the regulators should view consumers and the relationships between consumers and their advisers. To date the regulators have tended to assume that most consumers have the capability of being a rational "Econ" if only they have the relevant education.

The Editorial Board understands that work is ongoing in this field and that further work is likely to emerge later this year which explores the impacts behavioural economics has on consumers' need for education and the role of guidance and advice.

Consumer engagement; more than an at-retirement issue

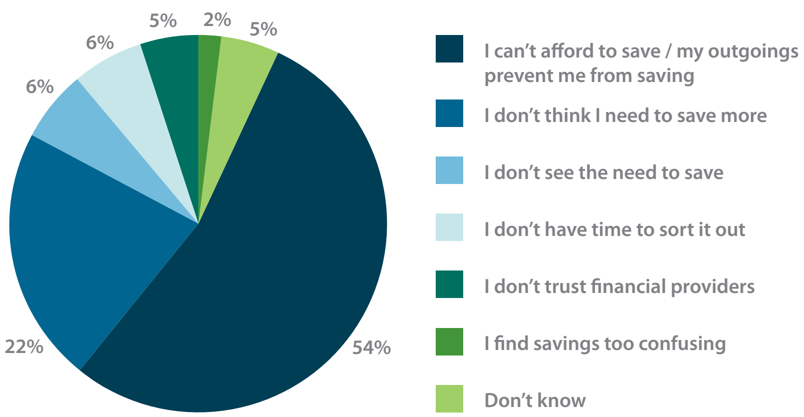
c. Consumer engagement; more than an at-retirement issue

Poor awareness of financial responsibilities is not restricted to decisions in the approach to retirement or during retirement. Similar poor awareness exists in the accumulation stage among people building pension funds, and about financial services in general.

In research conducted on behalf of PADA[xiii], the findings showed that pension purchases were generally considered to be less daunting and typically less researched than short-term financial products such as personal loans, cash savings, etc. Indeed, people often thought that decisions about pensions were even easier than those required for short-term products.

The reasons for this were thought to be clear: despite their perceived importance, few respondents had taken any significant decisions about their pensions. Many did not know that they could make decisions about their schemes before retirement, and most did not really want to. On top of this, pensions had little effect on life before retirement, apart from the contributions' erosion of disposable income, and respondents' lack of thought for the future had prevented them from considering what they would need to do to provide an income in retirement. NS&I research (chart 7) shows that over half of those interviewed believe that they can't afford to save or that their outgoings prevent them from saving.

Chart 7: Consumers' reasons for not saving more



Source: Quarterly Savings Survey, NS&I. Sample size: 3,000. Winter 2008/2009

d. Consumer responsibilities

The switch from DB schemes makes consumer responsibility particularly relevant. In DB schemes, the monthly salary automatically changes to a monthly pension for the duration of retirement, typically without any need for the individual to make a decision (other than to join) during their working life or at retirement.

By contrast, in the DC world, consumers have an extensive range of decisions to make while accumulating their pension fund; as they approach and enter retirement and during their retirement. It is clear that many individuals have not been adequately informed of what is required of them or the implications of their choices.

There are many complex areas where greater levels of consumer knowledge and awareness of their own responsibilities are essential:

During accumulation:

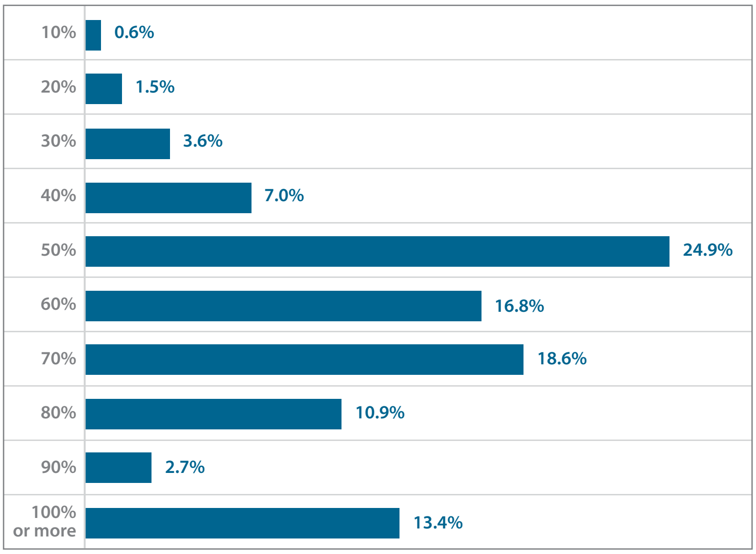
- **Pension contribution levels:**

  The Government is suggesting that, for Personal Accounts, the total annual contribution should be 8% of salary, up to a maximum of £3,600 pa, with 3% being the employer's contribution; the remainder comprises 4% from the employee and 1% from the Government.

Pensions Commission projections would make savers in Personal Accounts "under-savers". It is expected that contributions at this rate, together with the State pension, will provide median average earners with a retirement income that is 45% of their previous earnings. This is the baseline replacement rate of income that the Government is aiming towards[xviii] but this is lower than most people aspire to.

Research by Watson Wyatt[vi] (chart 8) indicates that on average, people expect to be able to live comfortably in retirement on an income that is 62% of the income they had while they were working. There is a demonstrable gap between the levels that people are being asked to contribute, the pension that contribution is likely to generate and people's expectations of a suitable retirement income.

Chart 8: Employees' views on replacement ratios



Source: Watson Wyatt Research Forum – The Future of UK Retirement Savings (2008). Sample size: 2,000 employees.
What percentage of your income do you think you will need to live comfortably in retirement?

- **Fund choice and default funds**

TPR[xix] conducted research which shows a wide variation in the number of funds offered on DC schemes, varying from a limited choice of three (equity, bond or cash) through to those that offer several hundred funds. In its research the comment was made:

"Some schemes have dozens, possibly hundreds of different investment options. There are different opinions on this but my personal view is that too much choice is a bad thing, it's better to have a reasonably contained choice of good managers covering a variety of different ways of investment. Some schemes will have a choice of half a dozen different UK equity managers – now how on earth are people supposed to be able to choose which of those to go for?"

Historically such options have been driven by conventional economic theory that suggests that more choice is better. However, increasingly focus is moving to behavioural economics which hypothesises that there is an optimum number of items to choose from, beyond which additional choices are likely to drive the average individual to make no choice at all.

The majority of DC schemes in TPR research offer a default fund, in which about two thirds of members choose to invest. Typically, once an investment has been made in the default fund, few members subsequently switch to alternative funds.

Although many of the default funds are lifestyle based, there are some mentioned in the research that have different investment mixes such as a combination of global passive and global active. As with multiple fund choices, many individuals will not be aware of the differences between such options or risks of funds with a potentially higher return.

The PADA research[xiii] showed that few of those interviewed were clear about how their contributions were invested, and even fewer knew that they could change these arrangements. In fact, few of those interviewed thought they would want to change the arrangements, or were sufficiently interested, or thought they were sufficiently knowledgeable and capable of doing so.

Approaching retirement:

- **State pension entitlement**

  ABI research[v] reported that 43% of people had no idea how much State pension they stood to receive and a further 30% said that they had only a vague idea. Only 8% of respondents had a very clear idea, with a further 19% being fairly clear.

- **Adequacy of retirement provision**

  According to the ABI, only 3% of working people are very confident and 31% fairly confident that they will have sufficient income to live comfortably during their retirement. In contrast, 26% are not at all confident and 33% not very confident.

  2008 ABI statistics indicate that 88% of the pension annuities purchased in that year were with funds below £50,000 (63% below £20,000). The median size fund pension was about £15,000; in today's environment, this would generate an income of around £920 per annum[i].

  The PADA research highlighted that respondents held a number of assumptions and expectations about income from pensions. One of the most common was that the income they would receive was fixed and out of their control. The second was that the income would not be as great as they had hoped for. Underlying both assumptions is a lack of understanding of pension projections that the individual might have received (and the acceptance that this projection is what they would receive). The latter assumption demonstrates a fatalistic attitude towards pensions generally and, partly, a mistrust of the pensions industry.

At retirement:

- **Flexible retirement patterns**

  The most common desired retirement age is 60 (suggested by 36 per cent of employees) but 65 is the most common expectation of actual retirement (suggested by 37 per cent). Workers have a desire to retire early but realise that this will be difficult to achieve; the gap between desire and expectation is greatest for the young and those on low incomes[v].

  Scottish Widows research[xx] showed that individuals envisaged retirement at 61 but accepted that they needed to be more realistic about when they could afford to retire, believing that 64 was a more likely age. Although more realistic, it still is earlier than the Government's move to a State retirement age of 68.

  Research by AEGON[xxi] indicated that 56% of those questioned in the "At Retirement Report 2008" intended to work past retirement age in some capacity. This move to a more flexible retirement is consistent with other evidence. For example, ONS figures indicate that, in 2008, 12% of people above the State Pension Age were in employment of some form.

  What many individuals do not understand, however, is that flexible retirement is not the same as moving to part-time employment before their expected retirement age. In the Scottish Widows research, 69% of individuals liked the idea of phased retirement, but expected to move to part-time work at 57 with full retirement at 63, marginally earlier than their expected full retirement age.

Product Choice

According to ABI data, the pension annuity market has grown by 11% per annum between 2004 and 2008. After initially rapid growth, the income drawdown market dropped in the middle part of the decade but has recovered and now surpasses the previous high level of 2002.

In 2008, about 91% of those taking an income from pension savings did so using an annuity contract with the rest using income drawdown. ABI data on the volume of contracts also revealed that, in the same year, 452,000 pension annuities were sold compared with 43,750 income drawdown products. Typically, those with larger pension funds opt for income drawdown.

Although it is likely that an annuity is the right product for the majority of individuals, it appears that, for many, such purchases are not necessarily made with full consumer knowledge and understanding. Clearly, it would be desirable to improve understanding and encourage engagement in the process.

Alongside the lack of understanding about the need to make a choice at retirement is a consequential lack of knowledge about how an annuity operates and its benefits.

- **Annuity options**

  Many individuals have little understanding of the underlying concept of an annuity. In its simplest form, an annuity is essentially a policy bought for a fixed sum of money from a life assurance company that guarantees to provide a monthly income for life.

Poor levels of understanding of the basic operation of an annuity mean that many individuals may not understand the factors that need to be taken into account when choosing an annuity, especially the trade-offs between income and the various annuity options.

A Pensions Institute report[xxii] commented that to allow for a like-for-like comparison the ABI best-practice guidelines suggest that the default annuity quote issued to a pension scheme member should be that of a single life, non-escalating annuity, with a 5-year guarantee. This position is consistent with actual purchasing behaviour in the annuity market, where 80% of customers opt for level annuities. However, the most appropriate choice of annuity depends upon the retiring individual's personal circumstances; health, marital status, other possible sources of income, and so on.

It is however important to recognise that, with an average fund value of about £25,000, and a median fund value of about £15,000, for a large majority of consumers the scope for flexibility or ancillary benefits is limited.

- **Poor health**

  Many individuals are unaware that if they smoke, are obese, have high-blood pressure, hypertension or diabetes, they may be entitled to a higher income because of allowances being made for factors that could decrease life expectancy.

- According to ABI statistics, enhanced annuities accounted for 10.3% of the 2008 decumulation market, up from 6.3% in 2006. It is not clear how many people are eligible for an enhanced or impaired life annuity, though Money Marketing suggested it could be about 40% of annuitants.[xxiii]

In retirement:

- **The role of property and equity release**

  More than 70% of the households with a retired person own the property where they live[xxiv]. The current aggregate value of property owned by the over-60s is £1,220 billion (January 2009). Estimates by the Council of Mortgage Lenders (CML) in 2008 state that the value of the property owned by the over-60s (assuming house prices increase by about 2.5% per annum in real terms) will be £1,600 billion in 2016 and £2,300 billion in 2026.

- The FSA's "Financial Risk Outlook" report for 2009 predicts that, should property prices fall by 30% from their peak, 2 million homeowners and 500,000 buy-to-let investors will be in negative equity. However, the effect of negative equity on older segments of the population will not be as great as for other homeowners because they typically have lower levels of mortgage (for 65-69-year-olds, only 9% of the households have a mortgage; for 70–79-year-olds, it is 4% and for the 80+ age group, it is 3%)[xxv]. Most significantly, older age groups typically bought their property at an earlier date and therefore, even taking into account recent drops in house prices, have still seen substantial overall growth.

  Fifty-four per cent of employees interviewed by Watson Wyatt[vi] say that their property would go some way to help to fund their retirement, be that through moving to a smaller property, via equity release or from the sale of a second property.

  Although the trend for using equity release schemes (specifically lifetime or reversionary mortgages) is increasing, this type of product suffers from a poor reputation – because of the mis-selling of shared appreciation mortgages – and, as a result, insufficient advisers are qualified and willing to give advice.

> "80% of customers opt for level annuities"

For many individuals, their property is their largest or only significant asset at retirement and, as such, they need to be aware of the possibility of, and various approaches to, using it as a source of income during their retirement. Many individuals have made a conscious decision to invest in property as a primary form of long-term savings but it is questionable whether they are equally knowledgeable about how best to use this asset to provide the income they require.

It is also important to recognise that attitudes change through an individual's life. The property investment made by a 30-year-old may be viewed in a different light when they consider, at 70, the home they have lived in for the past 40 years.

Because of the complexities of this area, it is essential that individuals seek out and receive advice from a qualified adviser to ensure that the full implications are understood.

- **Long-term care**

  The Government's discussion paper "The case for change – Why England needs a new care and support system" issued in May 2008 says that the existing care and support system is not sustainable, because of the challenge that changing demographics will have on the demand for and cost of providing care. The Government expects that more than 1.7 million more people will have a need for care and support in 20 years[xxvi].

  In 1999, the Royal Commission on Long Term Care for the Elderly recommended that the State paid for all long-term personal care. This has been ruled out because of the cost but the actual format for the long-term future of care provision is expected to be outlined in a forthcoming Green Paper.

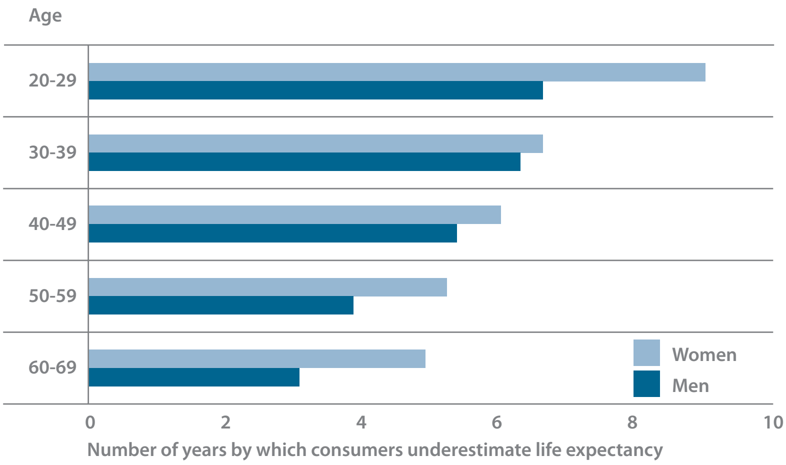
  At present, anyone in England who has assets of more than £21,500 is liable to pay for their own care (compared with £22,000 Wales and £20,750 in Scotland)[xxvii]. As a result, many elderly people are faced with funding the costs of long-term care and have been required to sell or utilise the value in their homes to fund it. Many are entitled to some State benefits but the rules are varied and complex and people do not always consult financial advisers to find out how they could be helped.

  People approaching retirement do not always consider the effect that ill health might have on the way they live, support they need and might increasingly need, and the effect this would have on their income, savings and quality of lifestyle. Approximately 1.26 million people receive local authority-funded social care, about 1 million receive community-based care and the remaining 260,000 are in residential care.[xxviii] These numbers will increase as the baby-boomer generation ages, increasing the overall retired population.

- **Expected longevity**

  Research[xxix] has shown that people tend to underestimate their life expectancy (chart 9). A man aged 20-29 will underestimate his life expectancy by 10 years, and those aged 60-69 by 5 years (for women, 6 and 3 years respectively). In fact, a 65-year-old man's life expectancy is 86.6 years, while for an 85-year-old man, it's 91.6 years.

Chart 9: Individual underestimates of life expectancy



Source: O'Brian, Fenn and Diacon, 2005, self-estimated life expectancy compared to GAD forecast life expectancy

In addition, the variability of life expectancy has to be taken into account. By definition, 50% will live beyond average life expectancy and, for example, 25% of 65-year-old men are expected to live beyond the age of 93. Making assumptions about retirement income and expenditure needs on the basis of average life expectancy therefore represents a significant risk.

This underestimation of, and uncertainty about, how long an individual might spend in retirement, even if they choose to work part-time into retirement, leads to the issue of running out of money.

A man aged 85 with a £100,000 fund, taking an income of £16,000 per annum will exhaust the fund by the age of 94 even with an investment growth rate of 6.5%, so 33% of people will outlive their assets[xxx] unless they annuitised their fund when they were 85.

- **Equity exposure**

  In its report "The Changing Face of UK At-Retirement Market 2009", Datamonitor predicts an increased demand for products that includes, among other features:

  - The ability to allow retirees to keep investing for the long term
  - Access to a wide range of funds, including property and equity

  This is supported by findings from National Association of Pensions Funds (NAPF) which indicate that investment considerations are relevant for those with sufficient assets or who are genuinely risk tolerant. However, less than 10% of the products sold in 2007 were of a type that allowed for continuing investment. Despite the availability of unit-linked and with-profits annuities, which combine an individual's desire for guarantees as well as allowing continued exposure to investments, only 0.2% of decumulation products purchased in 2008 were unit-linked annuities, 2.2% with-profits annuities, and 8.8% were income drawdown.

- **Bequests**

  The above mentioned Datamonitor report says that 61% of IFAs identify inter-generational passing of wealth as a priority for their clients. It is accepted that advisers tend to focus on the more affluent, but the idea of being able to pass something on to children or grandchildren is prevalent across all segments of the population.

e. Consumer sources of information

Consumer sources of information

There are multiple sources of information about all aspects of the pre-retirement, at-retirement and post-retirement markets available to individuals who seek them out. They range from the Government to third parties such as charities and industry bodies. For example:

- The Pensions Service website, provided by the DWP
- The Pensions Advisory Service website
- The media, including the numerous consumer information websites
- The Money Made Clear website, provided by the Financial Services Authority
- Insurance/pension companies
- Bank or building societies
- Independent financial advisers
- Charitable organisation such as Help the Aged and Age Concern
- Citizens Advice Bureau
- Employers

Employers with contract or trust-based schemes play a role in communicating information to their employees. This information takes many forms, as identified by TPR[xxxi], but, despite its importance, wide variations in the frequency, volume and types of member communication are apparent in different schemes.

> *"Mostly these variations are driven by employer interest and responsibility as with so many other aspects of the schemes, and strategies can vary from those employers who completely hand over communication to a third party, right up to those who are proactively looking for new ways of really communicating with and engaging their members."*
>
> [Source: Harris Interactive]

As part of evidence gathering ahead of writing the white paper, Ipsos MORI conducted primary research with 1,025 individuals aged over 40. Questions were asked of those who categorised themselves as being:

- Five years away from full retirement ("pre-retirement")
- Five years from having completely retired ("post-retirement")

The main focus of the research was sources of information about aspects of retirement[xxxii].

There was consistency between the two groups when it came to three of their top four sources, namely IFAs, banks and building societies, and family (chart 10).

The difference was that, for the post-retirement group, employers were considered a key source of information while relatively unrated by the pre-retirement segment (21% compared to 7%). It is important to note that individuals will often associate communications from their pension scheme trustees as being from the employer.

The pre-retirement group also considered an insurance/pension company with whom they were familiar to be a key source of information.

These findings are consistent with PADA[xiii] and Mintel[xxxiii] research.

The pre-retirement group used IFAs because they were considered trusted, knowledgeable and independent. The same traits were also most rated by the post-retirement group, but with independence as the most important reason, followed by trusted and knowledgeable.

Banks and building societies have a key role to play. For both groups, they were convenient, had an existing relationship with the consumer and were trusted.

The use of family as a source is more divisive. Although rated highly as a source, families also appear to be least likely to be used, suggesting a reluctance to discuss personal financial matters with family members.

The pre-retirement segment is more likely to use IFAs than those who have already retired (38% prompted awareness compared to 19%). This may be an echo of other findings that suggest people are over-confident in their ability to manage the necessary decisions; this confidence is challenged when faced with having to make actual decisions, leading to expert help being sought.

It is interesting that, for the post-retirement group, employers played a larger role than the pre-retirement group expected. The low recognition in the pre-retirement group for the role of employers marks a significant shift over the past 20 years. Communications from employers about and around DB arrangements often used to be seen by employees as a core source of financial education. This points to a challenge for employers to regain the recognition in this role that they once had.

It is clear that, to ensure as many individuals as possible are engaged and informed on the matter of retirement choices and decisions, there is a role for various channels of communication, guidance and advice.

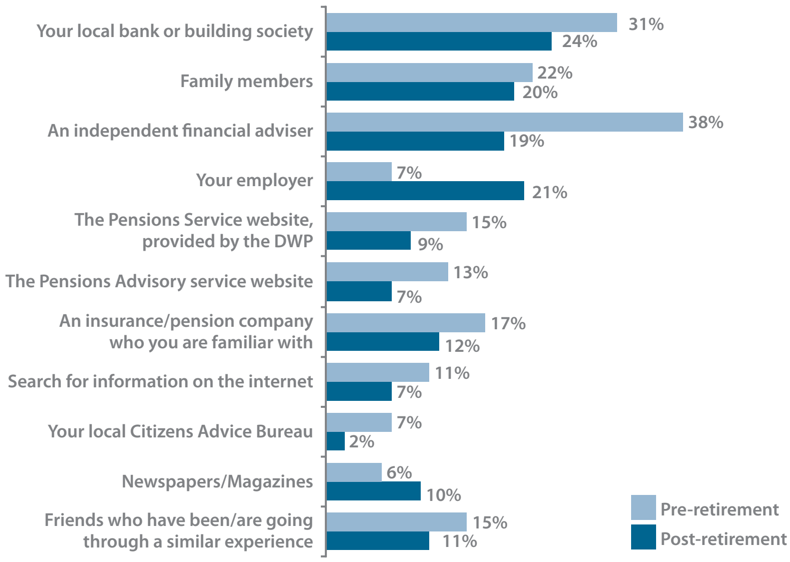


Chart 10: Sources of information for pre- and post-retirement groups

Source: Ipsos MORI research for AIFA (2009)

8. The distribution landscape

a. The Retail Distribution Review

The FSA's Retail Distribution Review has been well documented and commented on since its initiation in June 2006. At the time of going to print, we were awaiting the consultation paper and the next layer of information from the FSA. It may therefore be that some nuances have not been addressed in this paper. However, the fundamentals behind the review and the landscape outlined in FS8/06[xxxiv] are expected to remain constant.

According to the FSA:

> *"The Retail Distribution Review (RDR) is one of the core strands of our retail market strategy. It complements our aims to improve financial capability and further ensures firms deliver fair outcomes for consumers. It is essential for promoting a resilient, effective and attractive retail investment market. The RDR will modernise the industry, giving more consumers confidence and trust in the market at a time when they need more help and advice with their retirement and savings planning."*

1. Independent Advice

Generally, there is support across the industry for continuing to increase professional standards and for the need to separate the cost of advice from the cost of the product. However, there is concern that the suggested changes run the risk of reducing the overall number of advisers.

At the Watson Wyatt Debating Forum held in January 2009, the audience of product providers was asked about the possible effect on IFA numbers from implementing the RDR. Nearly half the audience said that numbers would decrease by up to 25% while a further 30% said numbers would decrease between 26% and 75%.

Therefore, at a time when there is clearly an increasing need for advice, there is a risk that the overall availability of advisers will decrease.

The Editorial Board is supportive of the FSA's RDR objectives. It believes that there is room for multiple options for an individual to engage with the financial services industry, whether generally or specifically in relation to the decumulation market.

Our support for the changes comes with some caveats. The threat to the overall capacity of the adviser market has already been mentioned. Other issues being:

- Whether the names assigned to the different channels are obvious to the consumer, making it clear what type of service it can offer and equally clear what it does not offer
- Whether the current proposals for professional standards and qualifications will enable those who wish to specialise in the decumulation market can do so alongside achieving QCA level 4 within the necessary timescales. From the research conducted with the large advisory firms, the clear message was the need to increase the numbers of advisers who were suitably qualified to advise holistically on decumulation products, including equity release and long-term care
- How the changes will or won't apply to the group pensions market. Many of those entering the decumulation market will have workplace pension schemes and, therefore, the way that guidance or advice can be provided within the workplace needs to be clarified.

b. The future role of independent advice

The value of advice has been extensively covered in a number of reports, including the AIFA paper "Financial Advice: Worth the Money?"[xxxv]. This paper concluded that advised consumers tended to improve their financial circumstances, their financial risk management and their longer-term financial situation. Benefits could be immediate, such as saving more and reducing expensive debt. In the longer term, risks were mitigated and consumers' principal concerns about income in retirement alleviated.

Advised consumers invested more and thus increased their chances of achieving an investment asset base to provide sufficient income in retirement and to cushion them against pre-retirement life risks.

The longer-term effect of this financial wellbeing was not only personal but also societal in terms of increased tax contributions, reduced need for benefit payments and the beneficial effects to the economy of wealth accumulation.

It has been shown as part of the AXA Avenue initiative that, if consumers in the low-to-medium income group were to receive advice, there would be clear benefits in terms of increased savings, better debt management, and higher provision for retirement.[xxxvi] There were other potential benefits in terms of a regulatory dividend for the industry, as more capable consumers required lighter-touch regulatory protection. The wider economy would also benefit as consumers became personally wealthier, increased their consumption and became more resilient to financial risk.

There are a number of factors that are expected to drive up the demand for advisory services:

- Increased number of individuals approaching retirement and in retirement
- Complexity of personal circumstances
- Assistance to achieve optimal income throughout retirement
- The role that housing has to play in meeting retirement needs
- Need to fund for care services
- Limited number of advisers currently qualified and licensed to provide such advice

9. Industry response

During the course of developing this paper, we sought the views of different participants in decumulation to ensure that this landmark study reflected the market's overall perspective of the challenges and issues. Included in this qualitative research were:

- Government and Regulators
- Product providers
- Trade associations
- Consumer groups
- Advisory firms

Appendix A outlines the organisations involved, and many thanks are given for the time that they gave freely.

The general view, across the different organisations, was that decumulation has typically been viewed on a silo basis rather than on a holistic basis – both in terms of the products that are available and by advisers, where only a few have developed a specific decumulation proposition.

As with any market, there are notable exceptions. There are clearly some product providers that see decumulation as a single market and have structured their propositions and strategy to meet its specific requirements. Likewise, there are adviser firms that have created a business model around the later-life market or built a specific service line into their existing model.

For the majority of organisations in the market, however, the lack of focus on decumulation has typically led to a disjointed approach – from the regulators and policy setters to some providers and advisory firms.

a. Government and the Regulators

1. The regulatory and legislative framework

The general view of those supporting the research was that "we are where we are" with regulation and public policy. We view it as backward looking to deal with specific issues on a piecemeal basis as they arise rather than seeking to develop a holistic approach, ahead of market developments.

The likelihood of a truly holistic approach is perhaps overly ambitious, considering that is has never been done. However, with growth in the market set to continue, there is a general view that a real opportunity exists for a review to take place and significant changes to occur.

There are a number of specific areas that our study suggests require specific attention:

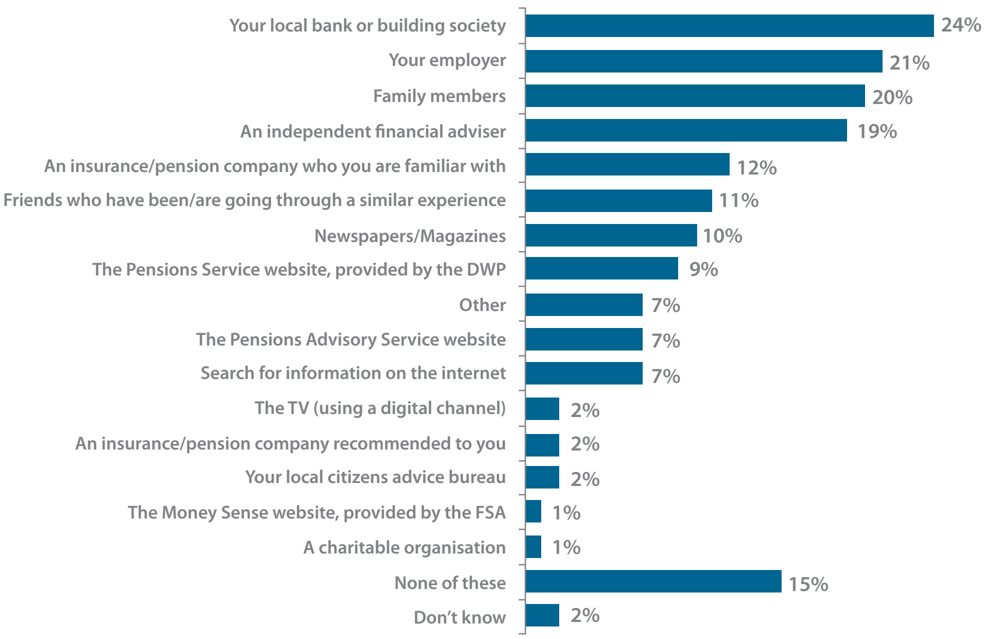
- The age 75 rules are based on historical factors which are no longer applicable and do not reflect current longevity; research shows that for some, the right time to annuitise is between 80 and 85.
- Current regulations largely consider retirement as a single period without reflecting how needs change throughout retirement. Research has shown that consumption and, therefore need for income, is likely to be higher at the beginning and end of an individual's retirement with a lull in the middle. Current regulations are largely based on a level rather than U-shaped need for income (where income requirements are high in the first period of retirement when individuals are still active, lower in the middle period as activity reduces and higher towards the end as residential care may be needed).

- The taxation policy on death benefits post-retirement is inconsistent in its tax treatment of individuals. Basic-rate taxpayers are entitled to 20% tax relief on pension contributions while higher-rate taxpayers (earning less than £150,000 per annum) are entitled to 40% relief. However, both segments are treated the same should they wish to protect the value of their wealth, with a tax rate of 35%.
- Conduct of business requirements for equity release fall under a different regime than other later-life products (MCOB rather than COBS). This makes it difficult for advisers to offer holistic advice covering all of an individual's assets.

2. Communications to individuals by the Government

The Ipsos MORI research conducted for the development of this paper showed that (chart 11), for those who had retired in the previous five years, only 9% had used the Pensions Service Website (provided by the DWP), 7% had used the Pensions Advisory Service website and 1% had used Money Sense from the FSA.

Chart 11: Options used to seek out information



Source: Ipsos MORI research for AIFA (2009) Looking at the list on this card, which of these options did you use to seek out information about turning your built up savings into an income for retirement? Please mention first the main option you have used. And which next? Base size: 136 – All adults aged 40+ who have retired completely within the last 5 years.

These results tie in with the fact that three quarters of respondents either disagreed or strongly disagreed with the statement: "The Government does all it can to help people through financial decisions at retirement."

The results are also a consequence of the large number of Government departments and regulatory bodies involved in communication around decumulation: DWP, PAS, FSA, TPR, etc. Each of these organisations has its own specific reason for engaging on the topic and the Editorial Board applauds and supports the wide range of programmes. However, the multitude of different sources can be confusing for the individual seeking specific information or guidance.

We believe that there needs to be an overall review of the various programmes offered, the material in the public domain and the way that information is communicated – its language, frequency and timing – and also whether coverage is comprehensive enough to reach everyone intended.

This is of specific importance given the comments in the FSA consumer responsibility paper from December 2008 on the importance of individuals understanding their "ownership" of decisions.

3. Social Care

As outlined earlier in this paper, housing wealth represents a significant proportion of overall wealth for the generations in or approaching retirement. For many, whether by choice or necessity, property will form an element of income in retirement. The publication of the Government's Green Paper on social care has a difficult job to ensure that individuals feel they have been treated fairly, balancing:

- The needs of those who have invested in their own home compared with those who do not have such assets
- The desire to bequeath wealth to the next generation, typically in the form of property as against the need to use such assets to fund for care or other retirement requirements
- Addressing the need to fund the increasing social cost of care against being seen to penalise those who have saved, whether in pension funds or in alternative assets such as property

Long-term care is an area that few in the industry have addressed. The cost of provision of such cover to consumers restricts the market to a few wealthy individuals, despite it being a market that many will need to access to ensure that they are suitably cared for.

The Government's Green Paper should articulate what individuals will need to provide for themselves and how, enabling providers to develop suitable solutions to meet these needs.

4. Future regulatory drivers

As a result of our study, it is clear that the current framework for setting rules and regulations does not always function as effectively as we would all hope. While significant efforts have clearly been made, the multitude of bodies involved has led to a disjointed approach and a lack of a common direction. It is essential that future regulations are designed to:

- Encourage flexibility and innovation within the market in the provision of guidance, advice and product development

"Long-term care is an area that few in the industry have addressed"

- Enable the industry to create and distribute a range of simple, well-constructed products that meet the needs of the mass and mass-affluent markets in a cost-effective manner, covering their immediate at-retirement needs for income, cover for care requirements and the ability to secure additional income from the equity in a property.
- Ensure that the rules relating to the provision of guidance and advice to consumers are consistent across all aspects of the market. As an example, IFAs have to conduct a detailed investigation into a client's circumstances to develop suitable recommendations for annuity purchase (usually via the completion of a factfind document). However, PADA has proposed that for Personal Accounts, this will be done using a form of guidance to facilitate individuals making decisions.
- Ensure consumers have sufficient and appropriate access to advice, guidance and information. Clarity in the way that guided sales and Money Guidance integrate with the provision of independent advice is essential.
- Avoid a one-size-fits-all assumption. Individuals' circumstances are becoming increasingly complex. For example, they have multiple employers, second families, are financing children's education in later life or experiencing a phased retirement. The current rigid approach to simplified decision processes and default options needs to be examined carefully to ensure that:
  - Default options are well designed and provide an appropriate level of protection and cover for the mass-market segment; and
  - those for whom the default options may not be the optimal solution are helped to make clear and informed decisions.

b. Product providers

1. Current focus of product providers

To date, the majority of the industry's energy and resources have been focused on the accumulation of wealth. Therefore, it is unsurprising that the decumulation market is regarded not as a specific, holistic market but as one in development.

As with any competitive, open market, there are organisations that choose to operate a focused strategy, within a specific product or consumer area, and those that look to serve the whole market.

There are product providers that take a holistic view of the market and have or are developing strategies and products that:

- Consider how the various decumulation products complement each other, irrespective of whether they offer all or just some of the possible product solutions
- Identify the consumer need that the product is likely to address and in which situation each one is suitable and, as important, unsuitable
- Work actively across different distribution and communication channels, transferring knowledge to the adviser community and other interested groups or organisations, such as charities

There are, however, other providers who focus on a specific tax issue or a single client need.

Many providers have become increasingly focused on the wealthier segments of the market as regulation has increased and the cost effectiveness of distribution to the mass market has become uneconomic. However, making products easily accessible to a wider audience of consumers was a repetitive theme in the meetings with market participants.

There is an expectation from the industry that guided sales and other straightforward sales channels, in combination with the development of simple, well-constructed products could help address the requirements of a larger number of individuals.

2. Product innovation

It is generally recognised that products in the decumulation market have to work for a long time, potentially 30-plus years. Therefore, while providers are continually devising new products and propositions, it is essential that consumers have confidence that they can and will deliver on their promises.

Consumers are attracted to guarantees and, in response, providers have been developing more flexible propositions that contain guarantees. However, as we write this report in the recession, concern about the accurate pricing of guarantees has seen companies increasing charges for new customers and has made other providers hesitant about entering the market.

The introduction of flexible-income annuities and, more recently, third-way products (variable annuities) has been appreciated for providing more choice at the point of retirement. However, there are concerns that some products are costly and unproven and, in some instances, whether they are right for the consumer.

This is compounded by concerns about whether some of the companies that provide such products in the decumulation market will be around as long as their products. This has increased in significance in light of the need for Government intervention in the case of AIG, the downfall of Lehman Brothers and The Hartford's recent withdrawal from the UK market.

The availability of income drawdown, unit-linked and with-profits and capital-protected annuities addresses consumer requirements for maintaining an exposure to the stock market into retirement and in providing some element of capital guarantee. However, the current take-up of such products is typically small. For example, according to ABI statistics, investment-linked annuity contracts represented about 2.3% of the 2008 annuity market.

3. The annuity market

Despite innovation in product design, as outlined earlier in the paper, the annuity market will and should remain, for many consumers, the primary route to converting pension assets to an income in retirement.

There is concern that the effect of the baby-boomer generation reaching retirement will increase demand on the existing annuity market at a time when capital is a scarce resource for providers. In addition, this will also increase demand for suitable assets to underpin annuity provision when these may be in limited supply. These factors have the potential to affect the cost to providers and their ability to provide sufficient capacity to the market. This, in turn, could affect the cost to the consumer and reduce the value they get from converting their pension fund.

Significant focus is often placed on the need to encourage the use of the open market option (OMO) for individuals with emerging funds to secure the best rates available at the time. For consumers with large fund values, this is clearly desirable where the benefit of achieving a higher rate can be significant. However, for lower fund values, the cost of obtaining advice can outstrip the benefit.

To make the process for the OMO simpler for consumers and their advisers to implement, many providers in the industry are taking part in an industry led money-transfer initiative, which aims to speed up the time taken for transferring accumulated funds between providers.

The expansion of the enhanced annuity market is seen as a positive development for the consumer ensuring greater fairness as annuity terms better reflect a consumer's individual life expectancy and most market participants wish to see that this trend continues to grow. There is concern that the process for taking out an enhanced annuity may become too complex as the underwriting processes develop. This, in turn, might deter some individuals from taking out the correct product for their situation. Access to reliable and responsible sources of information, guidance and advice is essential.

4. Equity release

There are mixed views from the market on equity-release products with many views still tarnished by the historical issues with shared-ownership equity release schemes. Equity release in its widest sense (including downsizing and other options to use property to provide income) is increasingly a necessity to help individuals supplement inadequate retirement income from other sources. However, there is concern about operating in this market because of:

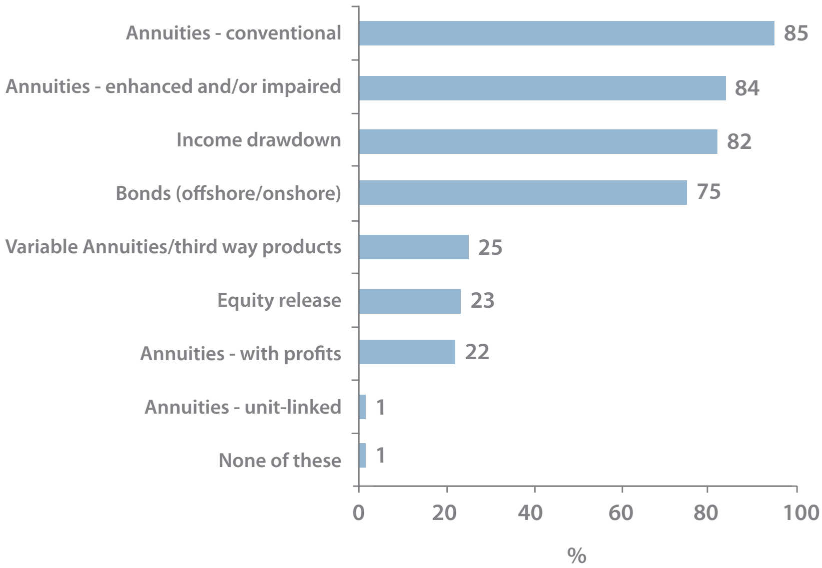
- The perceived need to be over-cautious when recommending such products, because of the perceived complexity of the product, the typical age of the client and the need to ensure that possible beneficiaries are included in the discussions and are comfortable with the route being taken
- The limited number of advisers suitably qualified to provide such advice.

Recent developments by organisations such as Safe Home Income Plans (SHIP) to improve the perception of that market have made inroads into these concerns, but there is still a long way to go.

5. Wider product provision

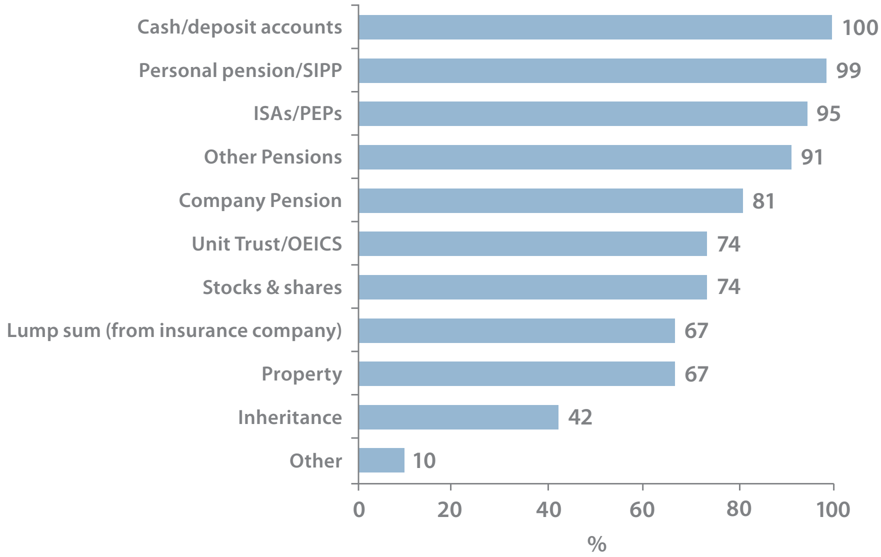
In discussing the decumulation market, much focus is often placed on the role of annuities, income drawdown and equity release. However, in our research it is clear that planning for income and wealth in retirement embraces a much wider range of products.

Chart 12 Decumulation products sold in the last 12 months



Source: Quantitative research conducted with advisory firms, April 2009 on behalf of AIFA. Which of the following decumulation products have you sold in the past 12 months? Sample size: 88

Chart 13: Typical advisory client assets at retirement



Source: Quantitative research conducted with advisory firms, April 2009 on behalf of AIFA. Which of the following sources of assets would a typical client have on reaching retirement? Base size: 88

While many of these products, such as investment bonds and ISAs, are often associated with the accumulation sector, they also have a valuable role to play in the decumulation market (charts 12 and 13).

The use of such products provides a clear reinforcement of the need to consider an individual's entire portfolio of wealth at and in retirement to provide for immediate income needs and ongoing wealth preservation in the most tax-efficient way.

6. Provider communications

A key role of providers is communication of their product range to consumers, advisers, employers and other organisations, such as charities. Across all groups in the research (including providers), there is concern that:

- The terminology developed by the industry doesn't necessarily mean much to the consumer. For example, "decumulation" was introduced to reflect the opposite of "accumulation" with neither term understood by the typical individual
- Providers develop their own language to try to differentiate themselves, leading to multiple terms being used to describe the same product or benefit
- The quantity of information can be daunting to the individual. An annuity pack for a consumer can be between 40 and 60 pages (although much of the content is dictated by regulatory requirements).

There is a clear onus on product providers to focus on developing communications that serve the consumers they are intended for, both in terms of language and volume.

7. Future provider focus

The continued move from product and segment silos to the holistic treatment of decumulation as a single, co-ordinated and integrated market should be a key focus for product manufacturers.

To meet consumer needs, there needs to be an integrated range of products to meet all requirements (not necessarily from one provider, but across the industry as a whole). Providers should recognise the increasing complexity of individual circumstances and provide for those needs through personalised advice while providing products that satisfy the more generic needs of the mass and mass affluent markets.

As the market develops, equity release and long-term care products should be integrated into the landscape alongside mainstream products such as annuities and income drawdown. Other products such as ISAs and investment bonds, which have an important role to play in decumulation, should also be included in the overall framework.

Improved communications should be a priority for providers. This includes rationalising industry-generated terminology to create a language that clearly explains different products alongside their pros and cons.

Providers should continue to work with advisers and other distribution channels to ensure that there is adequate and appropriate understanding of different products and of the consumer needs that they must specifically address.

c. Advisers

1. Current adviser focus

Comments from adviser firms that participated in the research were similar to those from the regulators, legislators and product providers. Generally, the decumulation market has received less focus than the accumulation market and is therefore less developed.

The focus on accumulation reflects the resources invested in that market by the product providers and the associated remuneration structures in place, which are typically more generous than for decumulation products.

Existing processes, licensing and compliance functions are considered to be fit for purpose. However, the increased awareness in the market is resulting in some firms seeking to make more specific guidance available.

In the research, many of the larger firms use specialist units to support frontline advisers on technical aspects. This approach has the benefits of:

- Standardisation in approach
- Maintaining the valuable ongoing individual relationship with a client
- Ensuring technical knowledge and capability at the front line.

There are multiple tools and software to support an adviser trying to make suitable recommendations for an investment portfolio for a client such as:

- Risk-profiling tools to help to identify the specific risk that an individual is prepared to accept
- Asset allocation tools to ensure that the wealth is suitably invested
- Wraps/platforms to manage the portfolio in a holistic manner.

Although the above tools can be used for the decumulation market, it was noted that there is specific software available to help manage a client's retirement income portfolio although it is less developed and less utilised.

It is widely recognised that the decumulation market is a strong growth sector and one with specific characteristics and needs. Firms acknowledge the need to enhance their services in this area but feel constrained by three key factors:

- The complexity of the market and the different elements that must be taken into account when developing suitable recommendations and the effect of product development
- The shortage of high-quality, suitably qualified advisers with specialist knowledge of the decumulation market
- Consumers' attitudes towards advice and the cost of such services, especially the viability of offering advice to those with more modest pension funds.

“It is widely recognised that the decumulation market is a strong growth sector”

i. Maintaining adviser knowledge and product development

As increasing numbers of individuals seek advice with complex financial arrangements and requirements, the need for the adviser to be aware of product and market information needs to be complemented with a knowledge and understanding of State benefits entitlements.

Product innovation and availability were generally felt to be improving choice and leading to greater flexibility in developing solutions in the decumulation market. In the traditional annuity market, some advisers make selective use of with-profits and unit-linked annuities and, particularly, enhanced/impaired life products. However, this innovation presents a double-edged sword to adviser firms in ensuring that their advisers' knowledge is up to date.

The increasing availability of variable annuities is providing further options. However, there are concerns about the real cost of guarantees in these products; and the recent increase in charges and withdrawal of products have done nothing to quell this concern. The complexity of variable annuities remains an issue for investors and advisers around how and when to use them. Further emphasis on developing the necessary understanding and engagement is required to bed down variable annuities in the same way as happened with income drawdown.

ii. The shortage of suitably qualified advisers

It is difficult to quantify the actual number of advisers operating in the wider decumulation market. For example, despite contacting the relevant bodies, it was not possible to ascertain the exact number of advisers who were qualified to provide advice on equity release products.

A decrease in adviser numbers, and the consequent effect that this would have for the number specialising in the decumulation market, is seen as a risk arising from the Retail Distribution Review. While advisers support the continuing increase in professional standards, there was concern it would be years before there was a generation of 'new blood' in adviser firms.

iii. Consumers' attitude towards advice and the cost of such services

There is general support for the work of the Government in terms of Financial Capability and the objective to improve consumer access to financial services through the implementation of the Retail Distribution Review. Improved consumer awareness of how to engage with the advice profession throughout their lifetime (not just at and in retirement) will lead to increased engagement and understanding of decumulation issues overall.

"We do need better educated and more knowledgeable consumers but it is not easy as to how you can stimulate interest in retirement planning among those who really need to be considering it (young but with other priorities on their plates)"

[Source[xii]: Advisory Firm]

Alongside this, advisers think it is equally important that consumers are educated on the costs of providing advice and specifically the significant time and resources that have to be invested by advisers unseen by the consumer.

Consumers are also not aware of the effect that regulatory costs have on advisers and helping to explain this more clearly to consumers would help them to better appreciate the cost of providing advice.

2. Advice to clients with lower wealth levels

Many advisers are keen to work with consumers with more modest wealth and are willing to explore the guided sales option. Research conducted by Watson Wyatt during February 2009 indicated that, of the advisers included in the research, 20% intended to offer guided sales as an option. However, there is concern about how a viable business model could be developed to satisfy this need when regulatory compliance is costly.

At present, many IFAs provide advice for clients with modest pension funds, which can be on a number of bases:

- Provision of information and guidance on where to go to seek the best annuity rate
- Focused advice on the annuitisation of a pension fund only
- Holistic advice across all of a consumer's requirements, which may be appropriate if the modest pension fund is part of a wider portfolio

A specific concern from some adviser firms was that most product development focused on the high-net-worth market but that the demand for advice was likely to expand into the mass and mass-affluent markets. A small range of well-constructed simplified products would be required to meet their specific needs.

3. The effect of regulatory change on advice

An area of concern for the adviser community is the ability to provide ongoing advice to clients within the changing legislative and regulatory environment.

A-day (the April 2006 pension reforms) was seen to create a more positive environment in which to develop and implement more flexible approaches to retirement planning and decumulation advice, leading to the growth in the utilisation of products such as income drawdown.

However, there were also negative aspects such as U-turns on allowable investments, Alternatively Secured Pensions (an alternative to purchasing an annuity at age 75), pension term assurance, etc. The most recent Budget has increased the complexity of the legislative environment with the introduction of tapered pension contribution relief for those earning more than £150,000 per annum.

Advisers construct recommendations and prepare plans for retirement income based on current legislation. Clients seek their advice to help secure a suitable income in retirement but this advice can be undermined by regulatory changes, sometimes applied retrospectively.

4. Future adviser focus

Ensuring that advisers are at the forefront of knowledge on products and the wider environment, such as State provision and benefits entitlement, is a key challenge for adviser firms. This requires support from product providers, Government and trade bodies, such as AIFA.

To help firms that wish to operate more significantly in the decumulation market, with suitable guidance on the most appropriate processes and tools, is a key priority. As a result of this study, AIFA is planning guidance notes for advisers to facilitate this process.

The potential shortage in overall adviser numbers, specifically those qualified to advise on the decumulation market, is a major cause of concern. While advisers support the drive to increase professionalism, doing this in a way that minimises the effect on adviser numbers is essential. QCA level 3 is seen as an important stepping stone for many advisers; it could be described as an apprentice level for many, enabling them:

- To start practising in a "safe", monitored environment while their work is overseen by a fully qualified adviser, thus with no risk or detriment to the client
- To conduct an economically viable role in an adviser firm
- To develop their understanding of all aspects of the theory and how they are applied in a real-life environment.

Advisers hope this has been addressed by the FSA in its consultation paper; its omission in the feedback statement is seen as an unintended oversight.

d. Employers

1. The current role of employers

A number of advisory firms engage with unions and employers to provide guidance around pension provision as well as more general financial planning assistance in the workplace. This can take the form of one-to-one advice, group sessions and seminars.

In many workplaces, the shift from DB to DC schemes also saw a drop in the provision of workplace financial planning assistance. However, this trend has been reversed in recent years with increasing understanding of the issues faced by employees in DC schemes. The introduction of Personal Accounts in 2012 will increase the level of provision but it remains to be seen how, if at all, this will change the approach by employers to education.

Watson Wyatt research suggests that the generation of employees – often known as Generation Y (those born 1980 to 1992) – that will form a growing proportion of the workforce over the coming years has different attitudes and expectations to those of previous generations. Generation Y has high expectations of employers and requires flexibility in employee benefits.[xxxvii]

Naturally, there are risks and costs that discourage the provision of workplace financial planning, such as employer concerns over potential legal claims in the event of poor decisions.

“The introduction of Personal Accounts in 2012 will increase the level of provision”

2. The future role of the employer

The majority of medium and large employers believe that they should offer more financial education or assistance to help employees manage their finances.

It is expected that there will be growth in the provision of guidance and advice through the workplace with the prime motivators for employers being:

- The desire to obtain an improved perception of reward (70%)
- Getting greater value from the employee benefit spend (33%)[V]

It is likely that, as the DC market matures, the effect of market volatility will have an increasing impact on those in workplace pensions. As a consequence, the benefits of managing the risks of poor DC pension outcomes are likely to move higher up an employer's agenda.

Current legislation enables employers to fund financial advice to employees to the level of £150 per employee as a tax-free benefit. This is a welcome start, but it is not widely publicised and could have a negative effect if it led employees to believe that this is a reasonable figure to pay for financial advice.

The Editorial Board believes that the workplace and, by definition, employers have a vital role to play in the education of individuals.

10. The future

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A single market

a. A single market

It is widely acknowledged that better coordination between all market participants is required, with the consumer as the primary focus. The starting point is a clear definition and communication of decumulation as a specific, holistic market covering:

- Pre-retirement, incorporating the five years running up to expected retirement, so that individuals understand what will be required of them at retirement, how they can make the most of the time remaining until retirement, and select an appropriate investment strategy in the run-up to retirement
- Retirement, covering the decisions that individuals face in considering how to optimise their income during the remainder of their life by utilising the assets that they have accumulated during their working life
- In-retirement needs, and the different ways of financing them, such as the use of investment bonds, equity release and long-term care products, for those with sufficient levels of assets and how the State plays its part

To support this, there needs to be a consensus on the language used. As an industry, we need to move to the point where we can say 'it does what it says on the tin, and what it says on the tin can be understood by the consumer and adviser'. We have to put ourselves into the shoes of the individual and use the everyday language that they do.

There needs to be greater communication about the appropriateness of the full range of products and their application to different circumstances during retirement so that advisers are comfortable recommending them and consumers are more confident about purchasing them.

b. Consumer engagement and education

Consumer engagement and education

As has been outlined in the paper, Government, the regulators and the industry are doing a significant amount of work to make information available to consumers. There is information available from a variety of sources and in different media. However, it does not matter how much information is available unless the consumer is engaged, which is not the case.

Therefore, there are further ambitious actions that need to be taken forward:

- The Government should conduct a thorough review of all existing communication programmes across the industry to understand what exactly exists, the level of use and, most importantly, its effectiveness for each segment of the market
- This review should engage consumers to understand what they require, when and through what means; this can be achieved through primary research alone or in combination with research already conducted by organisations such as ABI and PADA
- The review should take account of the lessons emerging from behavioural economics
- From the results, a coordinated market-wide approach can be devised that:

- Utilises different channels, e.g. Government, providers, charities, adviser community and employers
- Ties in with accumulation education. (This should start with Financial Capability, building on the introduction of Personal Accounts, and gear up about five years before expected retirement, to help the individual understand the choices that they will face when they retire and throughout their retirement)
- Focuses on communication being active, not passive

c. Streamlined, relevant legislation and regulation

There are many departments and organisations involved in the setting or monitoring of rules and regulations for the decumulation market. The result is an inconsistent approach to a market of growing importance. It is imperative that an integrated and holistic approach is developed.

There needs to be a review by the Government to ensure that legislation, taxation and regulation are fit for purpose to ensure the smooth operation of the market by the various industry participants.

The review needs to address the specific items articulated in the previous section, covering small items through to more significant mindset shifts, such as:

- More straightforward regulation that is reviewed less frequently to provide a stable base on which the industry can operate efficiently and with some degree of certainty
- The current multiplicity of departments dealing with the issue working to a common approach and to common objectives.

d. Access to advice

The objective of the Retail Distribution Review is to provide increased access to financial services by the consumer. Further, it aims to increase clarity about the different types of services on offer, from execution-only and money guidance through to independent financial advice. Individuals have personal preferences about how they engage with financial services, which is dependent upon a multitude of factors from:

- The type of need
- The individual's preferences for seeking out information and advice
- Whether they are 'Econs' or 'Humans'
- Affordability of independent advice or guided sales
- Past experiences of interacting with financial services

However, it is clear that, with growing numbers of consumers needing advice, any changes to regulations should aim to retain current adviser numbers in the industry and encourage new entrants into the profession.

e. Role of employers and unions

Some employers already provide access to financial advice for employees. With the introduction of Personal Accounts, and the mandatory requirement for all firms to have them in place or offer an alternative scheme, it automatically places the employer in a key role, and increases the number of employers engaging with their employees on financial services.

Employers and unions will be an increasingly important channel for engaging individuals in a trusted and objective environment. Employees and union members may look on this as a value-added benefit.

The existing tax-free benefit of £150 per employee should be reviewed to ensure it is adequate to provide an appropriate service and communicated more widely.

There is a role for IFAs and Employee Benefit Consultants to ensure that they promote the provision of information and advice, when engaging with employers or unions.

f. Completeness of current product range

The current product range offered by providers is thought to cover most of the needs of the high-net-worth market where providers have traditionally focused their efforts. However these are often presented as disjointed products rather than as part of an overall decumulation landscape.

There are products that sit outside the mainstream; specifically, equity release and long-term care provision. These have an integral role to play in the overall decumulation market proposition and need to be brought into the fold. Work already done by SHIP to promote and explain the benefits of equity release products is essential but there needs to be a wider acceptance by the regulators, some consumer groups and some advisory firms that these are appropriate products in certain situations. Therefore, we suggest that there needs to be an industry-wide education programme to help all groups understand where these products are applicable and how they can be best used by those interacting with the consumer.

Below this, there is a clear and growing need to develop appropriate products that have a wide suitability that can be distributed through all channels to meet the needs of the mass-market and mass-affluent sectors.

Alongside this the vital role of clear and consistent communications that allow advisers and consumers to understand how products work, and when they are and are not suitable.

g. Independent financial advisers

This possible reduction in market coverage will be occurring at a time when there is an expectation that the demand for advice, and specifically independent advice, will be increasing.

Levels of trust and satisfaction with the adviser community are generally higher than for other forms of advice and sales, and, with the combination of increased demand and decreased supply, there will be a need to encourage new blood into the profession. Some of the large IFA firms already have 'nursery' schemes which are bringing people through to the advice market; however, the numbers need to increase.

In terms of skills and qualifications for the decumulation market, firms should continue to review their training programmes to ensure advisers operating in this market remain at the forefront of knowledge.

As decumulation has not typically been considered as a separate market, there is an educational element, covering the construction of the decumulation market, its issues, scale and opportunities for the wider IFA audience. Through knowledge and experience, greater traction of the opportunities will be made, and more advisers will move into the market space.

In the meantime, there needs to be support from AIFA and product providers in terms of building understanding for some groups of advisers, encompassing:

- A broad description of the market and its dynamics
- What it means for the individual and how the adviser can help
- Specific customer needs and requirements approaching retirement, at retirement and in retirement
- The different types of products and propositions; which clients they suit, what their benefits and downsides may be, including equity release, long-term care provision, etc.
- How an adviser can develop a viable business model to address this specific market and its needs

h. Barriers

Barriers

Many of the actions listed will take time to implement and to affect a suitable degree of change. There are possible barriers that need to be understood and overcome to ensure that the industry has the best possible chance to deliver the best solutions for the individual.

Conclusions

The industry has tried for many years to engage with consumers and is still working on identifying the necessary push that will take consumers to the point of wanting to know about financial services.

In addition, there is the need to overcome the outdated consumer view that advice is free and that they should not have to pay for it. The challenge to the market is to provide effective, low-cost distribution, widening access to include employers in helping more people.

Another challenge will be to get the market to work together to address the decumulation issue. This will require:

- The industry to identify commercially viable products that can be provided to meet the needs of their customers
- Changing the language that is used in consumer communications and ensuring that it is consistent across the market

Although these challenges are not new, and the industry has not been able to address them to any significant effect previously, it should not stop us from working towards the right goal: that of a consumer who is aware of their responsibilities and choices and able to make them in an informed and educated manner. Further, all parts of the financial services industry need to provide consumers with the advice and products that they can trust and know will meet their expectations in the long run.

i. Conclusions

The eagerness with which the different parties participated in the preparation of this report indicates a widespread commitment to seeing people better served at and in retirement.

The Government, the regulators and financial services industry must work together to address the needs of our ageing population. This includes providing access to relevant information, guidance and advice, and by developing flexible and suitable products that meet changing requirements.

But personal responsibility is likely to be the watchword for the future. The focus for Government, the regulators and the industry should be on helping

> “personal responsibility is likely to be the watchword for the future”

individuals to plan appropriately for their retirement and make provision for their dependants.

There will be challenges ahead. Recent advances in behavioural economics help to explain the levels of inertia and unpreparedness for retirement. Most people are overconfident about the quality of life they can expect in retirement, often leaving financial planning until the last minute. The reality, however, is that with increasing numbers of people reaching traditional retirement age, the State will be unable to support anything but basic needs.

Based on this understanding of human behaviour, the Government and regulator need to introduce measures that 'nudge' people along a certain path. Auto-enrolment in pensions will help, but close attention will need to be paid to default funds and explanations around risks and rewards of different investments.

Equally, financial capability initiatives must appeal to all ages and sections of society, including people in retirement. Education and guidance must cater for a wide range of consumers: from those largely reliant on the benefits system through to those with more complex needs who are considering investment, care and inheritance issues.

Providers and advisers have a responsibility to talk in a more accessible manner, putting the needs of customers before simple commercial gain. An industry glossary of industry terms explained in consumer friendly language is a good starting point.

Policy makers must no longer consider retirement as a single period without reflecting how individual needs change throughout retirement. A holistic review of the market highlights that people's needs for income change dramatically over the different stages of retirement. The Age 75 Rules, equity release regulation and the understanding and use of the open market option are just three issues that require immediate attention.

Perhaps most pressingly, the regulators should use the RDR to increase access to professional financial advice and introduce measures that help to increase trust in financial services. We must not run the risk of reducing access to advice, precisely when it is needed most.

The recommendations outlined in this report require a considerable amount of co-operation and communication between diverse parties. However, the common thread is the consumer and the desire to ensure that they are appropriately prepared for what should be a healthy and lengthy retirement.

The solution is to work together if we are to avoid larger numbers of the mass and mass affluent markets relying upon State intervention in their retirement. AIFA and Prudential, the commissioners of this report, will continue to work together to promote this agenda. We urge others to join our campaign.

Appendix A - List of participating organisations

- Association of British Insurers
- Investment Managers Association
- SHIP
- Society of Later Life Advisers
- SVARfair
- FSA
- HMT
- PADA
- TISA
- The Pensions Regulator (TPR)
- Resolution Foundation
- Rowntree Foundation
- Pensions Institute
- Pensions Policy Institute
- University of East Anglia
- Age Concern
- Help the Aged
- Financial Services Consumer Panel
- AEGON
- Baigrie Davies
- JP Morgan
- Just Retirement
- Legal and General
- The Hartford
- Prudential
- Lighthouse Group
- Money Portal
- Sesame
- SimplyBiz
- AWD
- Buckles
- Hargreaves Lansdown
- Origen
- AON
- Watson Wyatt Worldwide

Appendix B - References

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ii Financial Capability: A Behavioural Economics Perspective, Consumer Research 69 (July 2008)

iii http://www.watsonwyatt.com/europe/news/pressreleases/press.asp?ID=18909

iv The TPR dataset is drawn from the universe of DB schemes eligible for protection by the PPF and liable to pay the PPF levy. The PPF covers certain defined benefit (DB) occupational schemes and DB elements of hybrid schemes.

v ABI; Retirement Savings in the UK: State of the Nation's Savings (2008)

vi Watson Wyatt: The Future of UK Retirement Savings (2008)

vii Pensions: Challenges and Choices. The First Report of the Pensions Commission (October 2004)

viii DWP Projections using the Government Actuary's Department's Retirement Pension Model, Great Britain only.

ix DWP Research Report No 558 Saving for retirement: Implications of pensions reforms on financial incentives to save for retirement

x DWP Work and Pensions Longitudinal Study (May 2008).

xi Local authority statistical returns (August 2007)

xii Qualitative Research conducted with national and network advisory firms as part of the development of the paper (April 2009)

xiii Cragg Ross Dawson; Awareness, knowledge and attitudes regarding the retirement process for PADA's target audience (August 2008)

xiv Financial Services Consumer Panel: Exploration of Consumer Attitudes and Behaviour With Regard to Financial Advice and the Implications of RDR Proposals (January 2008)

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xviii DWP; Security in retirement (May 2006); Pensions Commission; A New Pension Settlement for the Twenty-First Century (December 2005)

xix TPR: DC research (January 2008)

xx Iain McGowan, Understanding what clients want in retirement: how are post-retirement lifestyles evolving? IEA and Marketforce 'Flexible Retirement Solutions' conference (12 May 2009) xxi AEGON: At Retirement Report 2008 – The Age of the Grandad-olescent

xxii The Pensions Institute: Annuities and Accessibility; How the industry can empower consumers to make rational choices (March 2006)

xxiii Money Marketing (5 February 2009)

xxiv Safe Home Income Plans and Communities

xxv Cambridge Centre for Housing and Planning Research: Prospects for UK housing wealth and Inheritance

xxvi Personal Social Services Research Unit (PSSRU) projections. This estimate is for personal social services only – not the entire care and support system.

xxvii http://www.communitycare.co.uk/Articles/2008/10/15/109696/adult-care-green-paper-series-what-provision-should-be-paid-for.html

xxviii Commission for Social Care Inspection (CSCI): The state of social care in England 2005–06 (2006)

xxix O'Brian, Fenn and Diacon: self-estimated life expectancy compared to GAD forecast life expectancy (2005)

xxx NAPF: Investment today for tomorrow's needs: choices, challenges and change (Investment Conference 2009)

xxxi TPR; DC research: Data on the occupational DC landscape plus results of independent research (January 2008)

xxxii Looking at the list on this card, which of these options would you consider using / did you use to seek out information about turning your built-up savings into an income for retirement in order of preference? Please mention first the option that you would be most likely to use. And which next?

xxxiii Mintel: Retirement Planning – UK, Finance Intelligence (September 2008)

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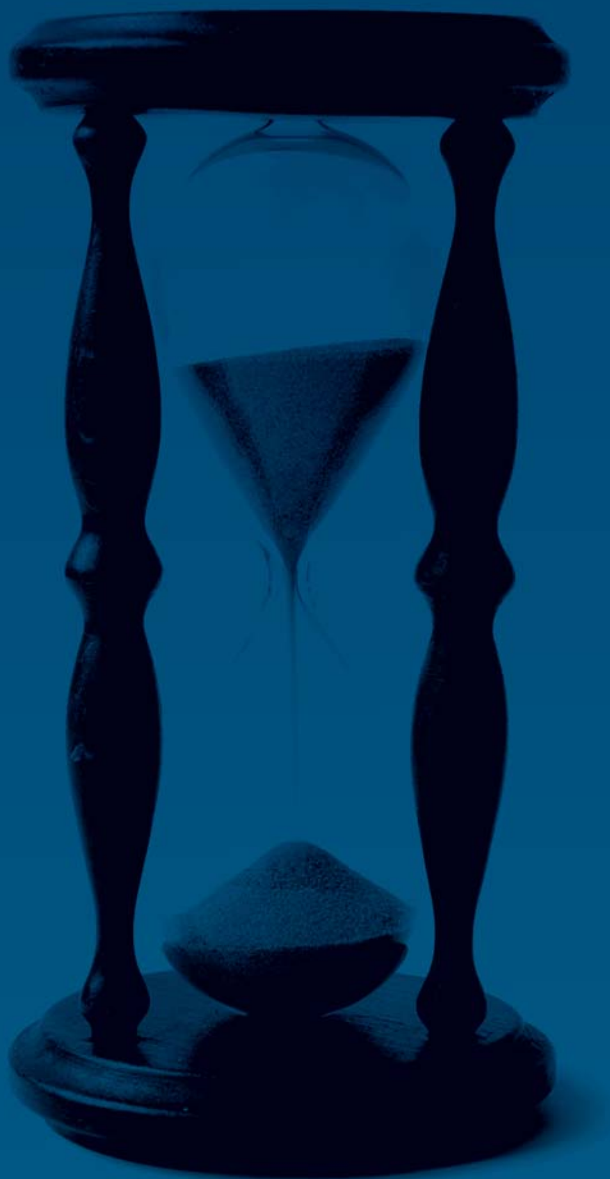

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