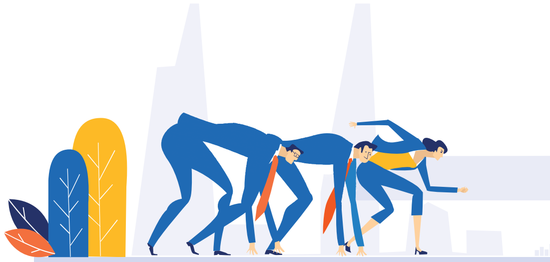

Summary
- The introduction of the freedom and choice pension reforms put the decumulation market under the spotlight, however, experts are disappointed with the progress so far.
- The debate still centres on annuities versus drawdown but there has been some development in the multi-pot area.
- There is an annuity-shaped hole in the market but there is potential for deferred annuities in the future.
- Other future innovations could include shared risk options and guaranteed drawdown products.

A marathon not a sprint

Five years on from the introduction of freedom and choice, how much development has there been in the decumulation market? Natalie Tuck reports

April 2020. It was peak lockdown for the UK, and most of us were likely hit by the reality of the pandemic, but it also marked five years since the introduction of the freedom and choice pension reforms.

Before the introduction of pension freedoms, most people with a defined contribution (DC) pension were forced into purchasing an annuity. The reforms changed everything. At the beginning of pensions post-freedoms the debate centred on annuities versus drawdown, with some schemes also offering the less flexible uncrystallised funds pension lump sums (UFPLS).

Five years on

Five years on and the debate is largely the same. Industry experts are disappointed by the lack of development within the decumulation space, but are not surprised. Cardano head of DC, David Bird, says there has been "some development but not nearly enough".

He says we should not be too surprised about this as the market is "pretty immature" and there is a "considerable readjustment required from the market norms that existed before".

Whereas, LCP principal DC investment consultant, Stephen Budge, believes that more effort has been put into engagement with retirees rather than product development. This is because, he says, many DC schemes do not have retiring members and even less in terms of assets so focus in this area has been restricted to making better use of already available funds and strategy options.

Multi-pots leading the way

Whilst the decumulation market has not strayed away from the three main products on offer; annuities, flexi-access drawdown and UFPLS, there has been some innovation within the latter two.

Pensions and Lifetime Savings Association (PLSA) head of DC, master trusts and lifetime saving, Lizzy Holliday, says that in the trust-based landscape, several master trusts are "leading the way in the development of new income drawdown solutions including multi-pot options that seek to address risks posed to retirees financial wellbeing in retirement".

"Multi-pot approaches have the advantage of addressing a number of risks the saver faces in retirement. But we consider more needs to be done to support and accelerate these developments, and to cover the whole of the market." Like Budge, she believes that innovation has been hampered by the smaller average pot size, which creates economic feasibility challenges for product development.

Earlier this year, Nest developed a multi-pot UFPLS offering, the Nest Guided Retirement Fund (NGRF), which launched in March. It features four different pots: The Nest Vault – which is split into two pots invested to provide money for the future and later life; The Nest Wallet – available for immediate cash withdrawals; and the Nest Safe – emergency cash for unexpected events. It is only available to members over 60 and with a minimum of £10,000, and will serve as a default option for those that don't make a decision upon reaching their state pension age.

The product was created following a large-scale market research project with its members over several years, explains Nest director of customer engagement, Mark Rowlands. The research identified four main customers needs: control, flexibility, support and assurance.

"It's very much picking up those principles and making sure we've done that in a way that helps our members," Rowlands says. "If you think about the risks to a member, they might live longer than they expect, they might spend too little or too much money. The NGRF is a way of giving them a sustainable amount of money for the rest of their lives."

There has also been multi-pot development in the drawdown space. One example is Brooks Macdonald, which launched a two-pot drawdown option in April 2019. The option is targeting a different kind of member to Nest, as the minimum pot size needed to take out the product is £500,000 and is aimed at medium to high-risk investors.

It divides client's money into a short-term portfolio, which aims to provide

0-7 years' income, and a growth element, which is designed to beat inflation risk over the longer term through diversified assets.

Annuity-shaped hole

Whilst drawdown and UFPLS have seen some innovation, the annuity market has been somewhat left behind, despite those in the industry agreeing that it is the best way to provide a sustainable income in retirement. So what does the future look like for annuities? The experts think that annuities still have a place within decumulation but not until later on in retirement. Bird believes an annuity will become an "endgame solution" for retirees at an advanced age, to ensure that they don't run out of money.

"The later in life an annuity is bought the value of the longevity protection goes up and the pricing of them improves because the lack of investment returns from the backing investments becomes less of an issue," he says. Budge, too, can see the appeal of an annuity purchased at 75 rather than 65, again highlighting the increased income by purchasing at a later age.

In addition, deferred annuities are not currently available in the UK but could offer potential innovation in the annuity market. It is something that Nest is keeping an eye on, says Rowlands. He notes that when Nest undertook its blueprint on the future of retirement, a US company was interested in launching deferred annuities in the UK but decided to delay this.

If they were to ever launch in the UK, the benefits, Holliday says is that they can offer better value for protecting against the risk of retirees outliving their savings. The PLSA expects them to make up a growing part of the retirement product market in the future, especially as interest rates normalise, and any changes to Solvency II may also serve to stimulate rates to the benefit of the saver.

Industry initiatives

Aside from innovation at a provider level, there is a wider industry effort to improve the decumulation market. The PLSA recently published a report on the decumulation market, which set out a framework to support savers. Explaining the initiative, Holliday says: "Our framework asks trustees to communicate with their savers about their options and also to signpost to a preferred solution. It asks trustees to consider various aspects of the product when they make their decisions about a preferred solution (in scheme or in another scheme).

"Our recommendations support innovative solutions coming to market. We expect the potential for products that tackle these needs to grow over time, as the size of DC pots grow and the demand side, supported by this framework, helps to shape the innovation.

"Innovative decumulation solutions could involve multiple products and, indeed, there have been some efforts to develop hybrid products. These are products containing multiple features that help savers to balance different needs."

In addition, the Financial Conduct Authority is introducing default investment pathways for those with personal pensions, but unfortunately the occupational side has been left behind. Bird says the pathways have "limitations that needs to be adapted and applied differently" for occupational pension schemes. The PLSA's report, nonetheless, has made recommendations to The Pensions Regulator on how this could work.

However, the PLSA's research found that the majority of trust-based respondents did not think pathways were suitable for their members, and felt that they could deliver more appropriate solutions that would not be pathways equivalent and that would not have been possible in contract environments. Some contract-based schemes also expressed the view that some of the best quality and high value options did not sit comfortably within the pathways framework.

Some are hopeful, however, that the pathways will help drive innovation. For example, Budge, who says such off-the-shelf strategies are easily comparable. In addition, Holliday says the PLSA believes the pathways are a step in the right direction.

Future products

In the grand scheme, five years is a short time in terms of progress in the pensions industry and the future holds several possibilities for the decumulation market. One option is risk-sharing products, such as collective defined contribution (CDC) schemes. Currently, the government is in the progress of legislating to facilitate the operation of CDC schemes in both the accumulation and decumulation phase.

Holliday says: "CDC pension schemes allow savers to pool their money into a single fund, which pays annual pension income. Pension increases vary depending on the funding level and modelling suggests higher member pensions are expected than under traditional DC annuities."

The PLSA's call for evidence found potential value in decumulation-only CDC arrangements, which will not, initially, be permitted under the government's legislative regime, she added. It is an area that Nest is interested in, says Rowlands, and the master trust will be joining an industry group looking at how such a solution could work in practise, and the regulatory and legislative hurdles.

Furthermore, guaranteed drawdown products could offer a middle ground between annuities and traditional drawdown, Holliday says. "They provide the benefits of pension drawdown, leaving a client invested in the market, and an annuity, which provides a guaranteed level of income until death. Depending on their structure, these products can offer inflation protection and some access to capital withdrawals. Several providers entered this market, but recently exited due to a lack of demand."

Written by Natalie Tuck