DB to DC transfers

A DC future

As we have seen in the previous articles in this series, more and more members are taking advantage of current flexibilities and the attractively large value being placed on their benefits to transfer away from defined benefit (DB) schemes towards their defined contribution (DC) counterparts.

In this third and final article in the series, we take a look at what members can expect from their DC benefits and how we expect this space to evolve over the coming years:

- What types of schemes can members transfer to?
- The search for income
- Future evolution of decumulation strategies

What schemes can members transfer to?

There are varieties of DC vehicles members are transferring to, all of which have different characteristics. The four main types of DC arrangement members might transfer to are as follows:

	Single trust	Master trust	Group Personal Pension (GPP)	Self-invested Personal Pension (SIPP)
Legal structure	Set up under trust and run by board of trustees.	Set up under trust and run by board of trustees.	Contract between individual and provider	Contract between individual and provider
Employer role	Likely to work in partnership with trustee board and have influence over scheme design.	Chooses provider. May select the default investment strategy from a range.		None
Investment strategy	Typically a designed default strategy, possibly alongside alternative member options.			Determined by individual
Decumulation options	Most schemes limit flexibility to allowing limited UFPLSs. Very few schemes offer drawdown. Members must otherwise transfer out to access more flexibilities or purchase an annuity.	Post retirement options are being developed. Provider may have own drawdown product available.	Provider will typically have drawdown product to offer. May also offer annuity options, though typically individuals will benefit from shopping around.	Individual can do their own drawdown, or select alternative product.
Costs	Vary – many more modern schemes provide excellent value for money though there remain legacy schemes with high charges.	Typically low cost	Variable – again many modern plans provide excellent value for money though there remain legacy schemes with high charges	Individuals will not benefit from the economies of scale of larger arrangements
Key advantages	• High governance standards • Little member input required • Can be tailored to suit employer • Control is retained by individual scheme	• High governance standards • Little member input required • Low cost modern solution • Low governance burden for employer	• Little member input required • Low governance burden for employer	• Full flexibility for individual
Key disadvantages	• Generally little flexibility, especially in decumulation • High governance burden for employer and trustees	• Little control for employer • Designed to suit the average • Emphasis on low cost	• Little control for employer • Designed to suit the average • Emphasis on low cost	• Relies fully on individual making their own decisions

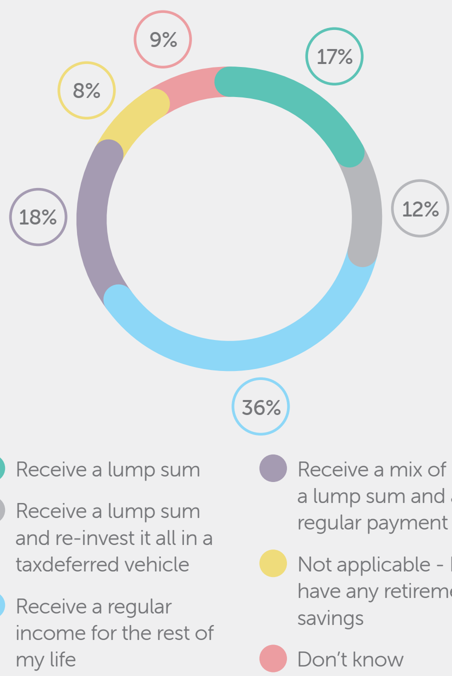
So, how well do these arrangements meet the needs of different members?

The search for income

One of the key differences between DB and DC is that most DB schemes provide an income after retirement.

If you ask people what they want from their pension savings, more than one in three want a lifetime income.

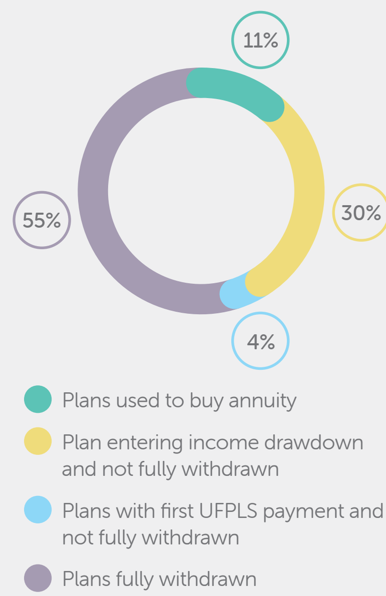
REGULAR INCOME IS WORKERS' SINGLE MOST PREFERRED WAY TO RECEIVE THEIR RETIREMENT SAVINGS IN RETIREMENT



Source: Aegon Retirement Readiness Survey 2019 - The New Social Contract: Empowering individuals in a transitioning world

However, if you look at what most people do with their pension savings without advice, they take cash:

RETIREMENT INCOME CHOICES 2018/19



Source: fca.org.uk/data/retirement-income-market-data#retirement

However, many members taking full withdrawal also have a DB pension to provide future income. The future generation of DC savers, and those who transfer from DB to DC, will not have this regular income stream to rely on.

Income drawdown

Under income drawdown, an individual first needs to decide the level of income to draw each year. Once this has been determined, the individual will then face the following risks:

- **Longevity risk** – risk of living longer than expected;
- **Investment risk** – risk of investment returns being lower than expected
- **Inflation risk** – risk of expenses increasing faster than expected.

> While investment risk and inflation risk can be carefully managed by investing in a diversified pool of assets designed to target a real return, longevity risk on the other hand, cannot be reduced under income drawdown.

This means that if all individuals aimed to only provide income until the end of their **expected** lifetime, a significant number (who live longer than average) would run out of money before they die.

The only real way to protect against this would therefore be to fund to a very old age. In this case there would be a high likelihood of dying with a large amount of remaining assets, which would be passed to the individual's estate. As the purpose of a pension is to provide an income on retirement for the rest of an individual's lifetime, this does not represent an optimal use of assets.

Annuities

In the UK, an individual can use their retirement fund to purchase a lifetime annuity from an insurance company which will provide a guaranteed income for life. Inflation-linked annuities are also available where the income provided increase each year in line with inflation.

Annuities can therefore be used to remove longevity, investment and inflation risk, and give an individual certainty in respect to their income in retirement.

In order to provide annuities, an insurance company will typically:

- Invest in fixed interest or index-linked government bonds which provide a guaranteed rate of return
- Provide annuity contracts across a large number of individuals in order to pool the longevity risk
- Include prudence when setting assumptions in respect of longevity
- Hold additional capital reserves to ensure solvency (i.e. all future payments can be met by total assets held)
- Incur expenses in administering annuity policies
- Aim to make a profit for shareholders who provide the capital required.

The impact of the above is that the level of income provided by an annuity is generally quite low. This has become a significant problem in the UK as falling real yields and improvements in longevity have led to even lower annuity rates. As these changes have not been anticipated by individuals approaching retirement, they now have to accept a lower level of income than they were expecting.

As the DC market grows and individuals choose not to purchase annuities, the number of individuals entering income drawdown at retirement is set to grow significantly.

The challenges of income drawdown

On retirement an individual will need to determine the level of income they can take during retirement. For those choosing to purchase an annuity this is a relatively simple process, as the level of income will be determined by the annuity rates offered by insurers at the time of retirement. The individual's risks will then be transferred to the insurance company leaving the individual nothing left to do other than receive the agreed level of income.

In addition to the risks faced under income drawdown, an individual is also faced with the challenge of understanding the following:

- How to actually convert a retirement fund into income
- How the level of income should change over time (e.g. as market movements occur)
- How investment returns will impact the income that can be provided
- How to determine what assets should be held in order to manage investment risk
- How charges arise as part of income drawdown and how these compare across different providers
- How to ensure that retirement funds do not run out

There are a number of models provided by financial advice services (often pension providers or government websites), that are aimed at helping individuals understand these issues and estimate how much income can be taken at retirement.

However, due to the significant uncertainty regarding many of these factors, it will be necessary to regularly revisit whether the level of income selected remains appropriate and make adjustments if necessary.

Investment pathways

The FCA has set out concerns that some members are crystallising their DC benefits purely to access their 25% tax-free cash sum, and the remainder of their DC savings are not being appropriately invested. So left to their own devices, it seems that members may make sub-optimal choices. In response to this, the FCA is introducing investment pathways aimed at members of GPPs and SIPPs who, having received prompts to take advice or guidance, decide to access their pensions through drawdown without taking advice.

From August this year, these members will be presented with a choice of four investment pathways to meet their retirement objectives:

- **Option 1**: I have no plans to touch my money in the next five years
- **Option 2**: I plan to use my money to set up a guaranteed income (annuity) within the next five years
- **Option 3**: I plan to start taking my money as a long-term income within the next five years
- **Option 4**: I plan to take out all my money within the next five years

In terms of the investment strategies underpinning each option, we can expect that option 1 and option 3 will be similar, focusing on inflation-protection growth via a diversified portfolio of assets with managed volatility. Option 2 is akin to many of the default DC investment strategies prior to the introduction of the pension freedoms, investing in long-dated bonds to hedge against changes to annuity prices. Option 4 focuses on capital preservation over a relatively short period and so will involve investing in short dated bonds and money market instruments.

However, research from the PLSA suggests that more scheme members are opting to stay in the trust-based environment post-retirement, rather than transferring to individual personal pensions. As consolidation in the market continues, we may see master trusts adopt a similar investment pathways framework for their post retirement solutions.

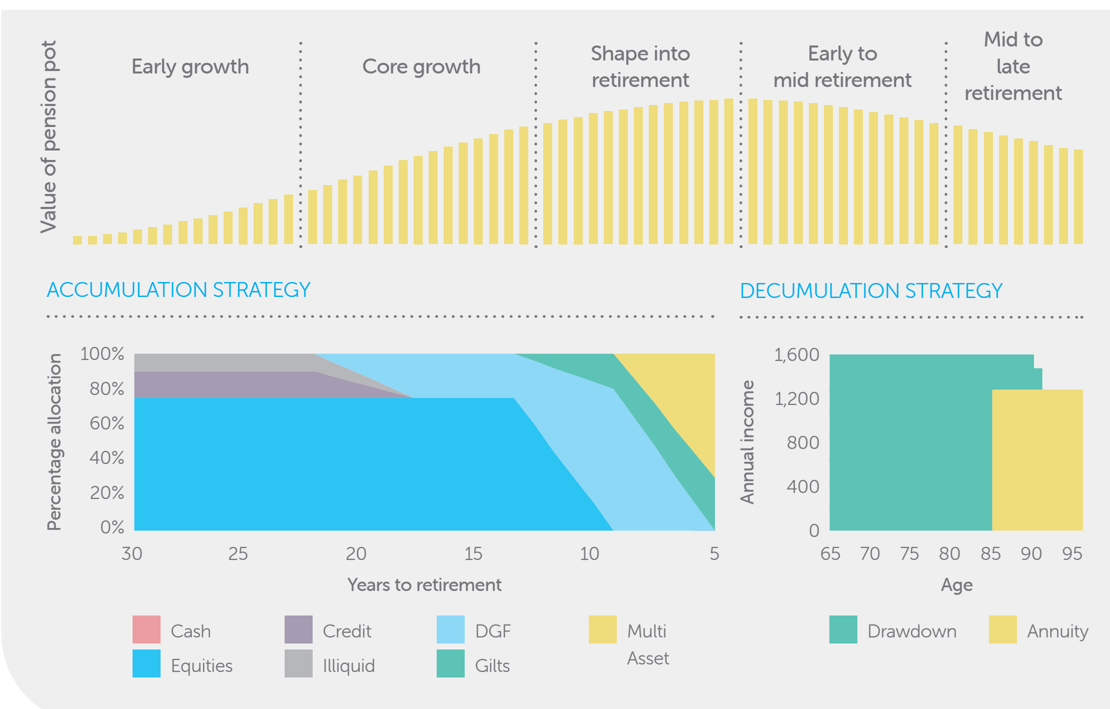
Future evolution

There is unlikely to be a silver-bullet retirement income solution to meet the needs of all retirees – the very spirit of the pension freedoms was to offer members flexibility.

In this world of pension flexibility, we favour an approach that allows members to select appropriate strategies for different objectives at different timescales (e.g. if members plan to take a series of lump sums, 'switch on' different levels of income at different ages and/or leave an amount for inheritance). We need to make it easy for members to follow a simple process that results in a bespoke, sophisticated investment strategy that meets their needs. This can either be multi-lifestyle or target date approaches so as to provide the necessary flexibility to allow members to structure their investments appropriately.

Successful post-retirement solutions will inevitably blend investment and insurance components. A volatility-managed, multi-asset drawdown solution would be the focus of income for the first 15 years or so of retirement (early to mid-retirement) with longevity protection in later life (mid-to-late retirement).

If this blend of strategies in decumulation is adopted, it would allow a member to control their own investments while also providing protection against longevity risk (i.e. an outcome that falls between income drawdown and annuities).



The following table summarises the comparative main features:

Feature	Income drawdown	New framework	Annuities
Income level	High (relative to annuities)	Medium	Low
Income certainty	Very Low (depending level of income and assets held)	Medium	High
Complexity	High	Medium	Low
Ongoing management	High	Medium	None
Flexibility	High (the level of income required can be changed at any time)	Medium	None (annuity purchases cannot be changed once made)
Benefit on death (inheritance)	Remaining Assets	None (Depends on Level of Mortality Pooling)	None
Investment freedom	High	High	None
Investment risk	Depends on assets held	Depends on assets held	None
Longevity risk	High	Low	None
Inflation risk	Depends on assets held	Depends on assets held	None
Determining level of income	Complex modelling based on assumptions regarding future experience	Simple modelling based on assumptions regarding future experience	Convert fund using annuity rates

Post-retirement products will need to extend beyond investment design to encapsulate a broader set of solutions including member engagement and guidance. For example, drawdown solutions will need to address the challenges set out earlier in terms of helping members to determine how much to withdraw without running out of savings, potentially at a time of declining cognitive ability.

BARNETT WADDINGHAM
beyond the expected

www.barnett-waddingham.co.uk

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics and challenges in more detail. Alternatively contact Sonia Kataora via the following:

sonia.kataora@barnett-waddingham.co.uk 0333 11 11 222

March 2020