Retirement Outcomes Review: The release of FCA Consultation Paper CP 18/17

July 2018

INTRODUCTION

On 28 June 2018, the Financial Conduct Authority (**FCA**) issued a consultation paper (**CP**), CP18/17 "Retirement Outcomes Review: Proposed changes to our rules and guidance" which set out its findings from its Retirement Outcomes Review (**ROR**) and a proposed package of remedies[1].

The CP is seeking feedback from industry on the FCA's proposals which are designed to:

- protect consumers from poor outcomes;
- improve consumer engagement with retirement income decisions; and
- promote competition by making the costs of drawdown clearer and comparisons easier.

Draft Handbook text which reflects the changes to Conduct of Business Sourcebook (**COBS**) for the proposals that the FCA is consulting on is included within the CP. It also includes list of questions which are divided into consultation questions (where the FCA is consulting on proposed change to rules) and discussion questions (where the FCA is seeking feedback on its proposals but not consulting on rule changes at this time).

The deadline for responses to discussions questions is 9 August 2018 and the deadline for responses to consultation questions is 6 September 2018.

For the proposals which FCA are consulting on, the finalised Handbook text will be published in a Policy Statement January 2019 after considering the feedback received.

For the proposals which the FCA has raised for discussion, the FCA plans to consider the feedback received and decide if the proposals need to be refined before consulting on the finalised proposals in January 2019.

FINDINGS FROM THE RETIREMENT OUTCOMES REVIEW

In June 2016, the FCA launched its ROR. This review was designed to evaluate the market for retirement income products purchased with defined contribution pension pots. The particular focus of the review was to assess how this market has changed since the introduction of "pension freedom" in 2015 and to identify and address any issues that might be emerging.

The full ROR report was published alongside this CP[2] (which follows the interim ROR report that was published in July 2017[3]). The three main findings of the final report are summarised below.

"MANY CONSUMERS HAVE WELCOMED PENSION FREEDOM"

Consumers have been taking advantage of the options now available to them. Since the new regulation, most consumers have accessed their pension pots before 65 and there has been a significant shift away from annuity purchase.

Whilst consumers are clearly making decisions that would not have been possible before pension freedom, given the long-term nature of retirement, whether consumers continue to welcome greater pension freedoms will depend on the financial outcomes based on these early decisions.

The low interest rate environment means that annuity rates remain relatively low and this is likely to be a significant factor in influencing consumers' behaviour in a post-pension freedom world. In a higher interest rate environment there may not have been such a dramatic shift away from annuities and there are a number of potential factors which could make them more attractive in the future.

The FCA also notes that it has not seen evidence that consumers are using their pension wealth unsustainably but does highlight that this is an area that they will continue to monitor.

The dangers of reckless spending in retirement have been discussed extensively in relation to pension freedom. Whilst 55% of pension pots have been fully withdrawn since the introduction of pension freedom, the FCA highlights these were mainly pots worth less than £30,000 and 94% of consumers who fully withdrew their pots had other sources of retirement income. Therefore, whilst it is positive that the FCA states that it has not seen evidence of unsustainable pension spending to date, the behaviour of those solely reliant on the defined contribution pots is yet to be borne out. The behaviour of current retirees may not be representative of future generations who will be increasingly

[1] FCA, June 2018, 'Retirement Outcomes Review: Proposed changes to our rules and guidance – Consultation Paper CP18/17'

[2] FCA June 2018, 'Retirement Outcomes Review – Final Report'

[3] FCA, July 2017, 'Retirement Outcomes Review – Interim Report'

reliant on their defined contribution pension pot as the primary source of funding in retirement.

"CONSUMERS NEED FURTHER SUPPORT AND PROTECTION"

The findings from the ROR suggest that consumers may not be making informed decisions as to how to invest their money and the FCA is particularly concerned that some providers are defaulting consumers into unsuitable asset classes such as cash or 'cash-like' assets. The FCA does not consider that cash is an appropriate asset for consumers who are planning on using their pot over a long time period and it is concerned that a third of non-advised drawdown consumers are currently invested wholly in cash.

On average, a 65 year old man is expected to live to age 83.5 and a woman to age 85. Investment decisions typically have to factor in the potential long term nature of retirement. Cash does not provide inflation protection nor is it likely to provide high enough investment returns to prolong the period over which consumers can draw an income.

"COMPETITION IS NOT WORKING WELL FOR SOME CONSUMERS"

The FCA is concerned by the lack of competition and innovation in the drawdown market. This is particularly an issue for non-advised consumers where there are low switching rates between providers. Over 90% of non-advised drawdown consumers choose to remain with their existing pension provider in comparison to 35% of advised consumers.

In addition the FCA has found that the charging structure for drawdowns is complicated and this does not allow consumers to easily compare products.

The FCA is also concerned that customers 'do not fully engage' with the product literature they receive from drawdown providers.

Often non-advised consumers are less financially literate and have smaller pension pots at their disposal than those who seek financial advice. More succinct documentation and more readily comparable charges should incentivise further competition in the market which should in turn result in better consumer outcomes.

PROPOSED REMEDIES

The CP includes details of the FCA's proposed 'remedy package' which has the following stated aims:

- protect consumers from poor outcomes;
- improve consumer engagement with retirement income decisions; and
- promote competition by making the costs of drawdown clearer and comparisons easier.

The objectives for the FCA's remedy package serve to highlight the change in the retirement income landscape. Prior to pension freedom, 'a poor outcome' for a consumer could be easily defined - purchasing an uncompetitive annuity or dying much earlier than expected. In the post-pension freedom world consumers must find a retirement wealth solution which balances longevity, inflation, investment and sequencing risks for themselves and so a 'poor outcome' is much harder to define. Furthermore, it could change at different points in retirement.

Consumer engagement with retirement product decisions is not necessarily a new problem, but it now has the potential to make a more material impact on the outcomes for those consumers than ever before. In the non-advised segment, the number of important decisions left to consumers post-pension freedom means that there is a much wider range of outcomes that a consumer could experience as a result of their own choices.

The FCA also highlights that making the costs of drawdown clearer will make comparing products easier. However, whilst we welcome the idea of transparency in relation to costs, in sharp contrast to annuity rates, costs are not the only metric that should be used to judge a drawdown product. The range of investment funds and fund performance are also important aspects of drawdown products.

Annex 3 of the CP contains a summarised list of the 39 questions which the FCA are asking for feedback on, and Appendix 1 contains draft Handbook text which reflects the proposed changes to COBS.

PROPOSALS FOR CONSULTATION

The FCA are consulting on making the following changes to the rules. The deadline for feedback on these proposals is 6 September 2018.

Wake-Up packs

Currently the FCA requires firms to send a 'wake-up' pack to consumers between four to six months before the consumer's intended retirement date. This contains: the money advice factsheet, a summary of the customer's open market options, information about the customer's pension scheme (including their pension pot size) and a statement about the availability of pensions guidance.

In addition, 6 weeks before a consumer's retirement date, the firm must send them a reminder and recommend that the customer seeks appropriate financial advice or guidance.

The FCA proposes altering the timing and frequency of wake-up packs so that wake-up packs are sent at the following trigger points: age 50, 4 to 10 weeks before age 55 and then every 5 years until the customer's pension pot is fully crystallised.

In addition, the proposals would alter the content requirements as follows:

- Removing any marketing or promotional material about the firm or its products from wake-up packs.
- For the wake-up pack at age 50: only sending a single page summary document and a retirement risk warnings document.
- For all future wake-up packs after age 50: including contents as per the age 50 pack but also including open market options and a money advice service factsheet

The term 'wake-up' packs suggests that customers may not have been thinking about their retirement prior to receipt of the pack. It's never too early for consumers to be considering their retirement 'readiness' and firms should consider that the earlier that customers are reminded about the retirement, the greater the chance that customers can make active decisions to improve their future retirement finances. Milliman consultants have produced a paper, in collaboration with Royal London, on the impact of decision making in the accumulation phase of retirement[4] which demonstrates the importance of making pension contribution decisions as early as possible.

The proposal to simplify the initial 'wake-up' pack is clearly an important step if the FCA wishes to improve consumers' engagement with retirement decisions. However, when providing information at an earlier age firms should make it clear what, if any, actions consumers are expected to consider on receipt of the first pack. The FCA has deliberately decided that firms should not include information about the product options at age 50 because it feels that this could confuse customers (given they are not able to access their pots until age 55). Therefore, it may be useful to make it clear to consumers why they are being contacted and what they should do as a result of it.

Information on Annuities

For consumers who have expressed an interest in purchasing an annuity, the FCA proposes to:

- require firms to ask questions to determine a consumer's eligibility for enhanced annuities and use this information to generate a market-leading comparison quote; and
- amend the annuity information prompt requirements so that consumers can specify an income and will receive a quote comparison on how much it will cost (income-driven). This differs from the current 'purchase-price' system where consumers receive quotes comparing the income they could receive based on their pension pot.

Providing an enhanced annuity quote, if applicable, would be advantageous to customers to ensure that the quotes they receive reflect the best value product given their circumstances. However, firms would have to consider how best to ask the necessary questions to be able to produce a quote, including thinking carefully as to how this is positioned and striking a balance between asking too many questions and not receiving sufficient information.

We welcome the income-driven approach to annuity quotes as it should make it easier for consumers to design a retirement income strategy that includes some level of guaranteed income but which retains some flexibility and investment upside by investing the remainder of their pot in a drawdown product.

Information on Drawdowns

For consumers who are entering drawdown, the FCA proposes amending Key Performance Information (**KPI**) requirements as follows:

- including a 'front page summary' of key information;
- including a one-year single charge figure (expressed as a cash amount);
- including the impact of inflation in all figures presented; and
- providing KPI to consumers who are either using an existing contract to move funds into drawdown or taking an income for the first time.

For customers in drawdown products, the FCA proposes altering the requirement on annual statements so that they include text on reviewing decisions and investments, and the need to consider a review of pension decisions made are provided to consumers who have not taken an income.

Whilst improving transparency of drawdown costs and charges will assist customers compare products, the FCA's focus on costs may imply that this is the most important metric by which to judge a drawdown product. A cash heavy investment strategy is likely to appear favourable from a cost perspective in comparison to an equity based strategy or more complex actively managed funds. However, this does not mean that it is the best option for customers. Therefore, cost should be considered alongside the range of investment funds available and fund performance.

The requirement to only express charge figures in cash amounts may lead to poor decision making. Fees may appear high in absolute terms but be small as a proportion of the total assets invested. This may lead customers to make inappropriate investment choices to reduce costs if they are making decisions based purely on costs. We would question why the requirement could not be extended to provide single charge figures in both absolute and relative terms.

[4] Milliman, June 2017, 'The decision citizens: Exploring the retirement challenges facing future generations'

PROPOSALS FOR DISCUSSION

In addition, the CP asks for feedback by the 9 August 2018 on the following proposals. These proposals are not being considered for rule changes at this stage because the FCA needs to do further work to establish how the proposals can be applied to Self-Invested Pension Plans.

- Requiring firms that offer drawdown products directly to consumers (without financial advice) to provide a range of 'investment pathways'. The FCA has proposed that firms offer a 'ready-made investment solution' designed to serve the mass-market. Each solution would correspond to a broad policyholder objective. Currently, the FCA is proposing that firms would offer a different investment pathway to meet each of the following objectives:

  1. "I want my money to provide an income in retirement."
  2. "I want to take all my money over a short period of time."
  3. "I want to keep my money invested for a long period of time and may want to dip into it occasionally."

The FCA has also suggested the following additional objectives but it is keen to gather industry views on the objectives.

4. "I want to take my money out flexibly during retirement."
5. "I want a guaranteed income for the rest of my life (i.e. annuity)."

Defining an investment strategy in terms of policyholder income objectives is a positive and important step to engage customers – typically drawdown investment strategies are defined in terms of investment risk which is a metric that may not be readily understood by consumers and is unlikely to coincide with their own objectives.

However, it is unclear whether the FCA intends that firms offer readily comparable (e.g. standardised) strategies. If similarly named strategies are not in fact similar across different companies, consumers may still make suboptimal decisions based on a superficial comparison.

We think that mentioning the option of guaranteed income is important (as the FCA propose in their 5th policyholder objective) even if customers have initially disregarded the option of an annuity. Consumers with small pension pots and low levels of other savings are likely to have a smaller capacity to absorb uncertainty. Therefore, it would be beneficial to remind customers of the option to have a guaranteed income source when discussing their retirement objectives.

- Preventing drawdown customers investing by default into cash or cash-like assets and therefore ensuring that customers are only invested in cash through a drawdown if this was an active choice.

Whilst cash is an inappropriate asset for long-term saving, there are circumstances where it might be appropriate to default a customer into cash. For example, if a customer has not chosen an investment objective for their pension pot then cash has the benefit of flexibility by being a liquid asset and not exposing the customer to sequencing risk. Therefore, cash should not be ruled out as a default strategy until the customer's objectives (or lack thereof) have been explored.

- Requiring firms to provide consumers with information on actual charges paid (expressed as a cash amount).

As discussed above, only presenting charges as an absolute amount may make reasonable charge levels look high and it could lead customers to choose funds based on costs alone rather than considering an appropriate investment strategy.

HOW MILLIMAN CAN HELP

Milliman supports product providers in enabling their customers to achieve better retirement outcomes. We have a deep understanding of the retirement market and continue to produce insights in the area as well as providing market analyses and market entry support.

If you have any questions or comments on this paper or any other aspect of retirement products and solutions please contact the consultants listed below or your usual Milliman consultant.

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