Written evidence from Bloomfield Financial Consultancy (APS0058)

INTRODUCTION

Decisions consumers take when accessing their pension savings invariably have many dimensions to them. These are very important long-term financial decisions which can have profound consequences and are often irreversible. Most consumers are ill-equipped to make such complex financial decisions.

Some customers will benefit from regulated financial advice. But many, so called 'non-advised' customers, are effectively making the decisions themselves. Evidence is already indicating, for example, that many people are taking income at a level which is not sustainable. The perils of doing this might not come to light for very many years – when the customer's pension pot has dwindled to nothing – by which time it is too late.

The risk of consumer detriment is clearly heightened where they do not benefit from regulated financial advice. This response to the Committee therefore focuses on non-advised customers.

EXECUTIVE SUMMARY

In terms of good outcomes for customers, the evidence points to:

- One very positive step in the right direction;
- Three demonstrable failures; and
- One area where the jury is out.

<u>FCA's Investment Pathways – a big tick in the box</u>

The Investment Pathways initiative is most definitely a force for good. The risk of consumer detriment is certainly reduced by the introduction of four outcome-focused objectives which are readily understood. Consumer research shows that 9 in 10 savers found an Investment Pathway option which matched their needs.

Following the implementation of Investment Pathways in February 2021 there will doubtlessly be a lot to be learned from their application in practice given they are, in many ways, a new concept. And so it is welcomed that the FCA has committed to a full review in 2022.

<u>Customers in trust-based schemes – let down by DWP and TPR</u>

The consumer protection provided by the FCA's Investment Pathways is not afforded to customers who are in trust-based schemes. DWP and TPR do not appear to have offered so much as an explanation as to why trust-based customers do not deserve similar protection. And this is all very concerning given the joint regulatory strategy that is supposed to exist between the FCA and TPR.

DWP and TPR must be encouraged to break their silence and explain what their plan for protecting consumers is and the reasons behind it.

<u>Customer communications on Investment Pathways – product provider efforts wide of the mark</u>

Having chosen an Investment Pathway, it is incumbent on the product provider to communicate to the customer the riskiness of the investment solution in a way that enables them to assess whether it is right for

them. With customers having chosen an option to match their needs, you'd have thought the risk would have been described in terms of possible outcomes. Wrong – most communications, regardless of the Pathway chosen, are just based on the risk that the investment solution might fluctuate in value. Such an approach fails to recognise that each of the Pathways is designed to meet a different customer objective.

When considering taking income in retirement, the single most important factor which needs to be taken into account when communicating risk to consumers is related to their ability to take risk with their income (which is often called capacity for loss). An approach based on the risk that the investment might fluctuate in value is largely meaningless to consumers who want to know what level of sustainable income they can potentially take and what fluctuating investment performance might mean to their retirement income.

When it comes to communicating risk to consumers, the FCA review in 2022 cannot come soon enough.

Annuities have a part to play – but product bias in favour of drawdown is being applied by some

When projecting income in retirement, a number of product providers appear to be using the FCA's illustration rate of 5% pa as if it were a realistic assumption. They are showing to customers that, even after a charge of 1% pa is applied, they can take withdrawals for life at 4% pa with all their capital still remaining intact. Or, put another way, if the capital is to be also used to fund withdrawals over expected life expectancy, then a 60 year old male can take withdrawals in excess of 6% pa. Such a projection is unrealistic in current investment market conditions and represents product bias in favour of drawdown over annuities.

In using the 5% illustration rate, there is a requirement on product providers to ensure that the rate is realistic. This does not appear to be being applied. There is perhaps the opportunity for the FCA to remind product providers of their responsibilities in this area.

Guidance – can it provide the support that customers want and need?

Even were the communications to be much improved, many consumers will still want the reassurance that they are making the right choice for them personally. They might contact their product provider or Pension Wise. Behavioural science tells us that consumers do not want to be told 'on the one hand this, on the other hand that, go figure'. Consumers want to be reassured that they are making the right decision for them.

It is imperative that the so-called boundary between 'guidance' and 'advice' is fully explored from the consumer perspective. The system should be designed so that it delivers what consumers want and need.

ABOUT BLOOMFIELD FINANCIAL CONSULTANCY

We are a small specialist management consultancy with a focus on the pensions market and a particular interest in public policy. We consider issues from the perspective of the customer – but, at the same time, we believe that efficient well-managed product providers should be allowed to make a profit.

Ian Costain is the Director and has been an independent consultant, with a focus on pension policy, for over 12 years. He has done advisory assignments on pension policy at both the Financial Conduct Authority and The Pensions Regulator. Independent Governance Committees (IGCs) took on new duties related to non-advised drawdown in 2020, and Ian was an independent member on two such IGCs during the period that Investment Pathways were launched.

INVESTMENT PATHWAYS

Were it not for pension freedoms then non-advised drawdown would not be a prominent feature of the pension landscape. Whether or not non-advised drawdown is in customers' interests is a separate debate. In terms of pension freedoms, the regulators can only really deal with the hand they've been dealt by HM Treasury.

Reducing the risk of consumer detriment

It is very difficult to argue against any remedy which is effective in reducing consumer detriment. Investment Pathways focus on consumer objectives by identifying what for them are the outcomes they are seeking from their pension savings. Sure, their use in practice will identify areas where they can be further improved, but before they were introduced they were subject to rigorous consumer research and testing.

And also the consumer research carried out by NMG Consulting for L&G, which surveyed nearly 1,200 savers on what they thought of Investment Pathways, indicated some positive findings too … https://www.lgim.com/landg-assets/lgim/_document-library/capabilities/defined-contribution/investment_pathways_research.pdf.

The consumer research found that 9 in 10 savers found an Investment Pathway option which matched their needs. And 60% of respondents were positive about Investment Pathways, with Generation X in particular finding them useful for their retirement planning (almost 70% of retirees-to-be under age 55 being positive about them). There will always be a group of more engaged and confident savers for whom the concept of Investment Pathways will seem too basic. In this context the figure of almost 70% finding them useful is particularly encouraging, demonstrating that the policy intervention is targeting precisely those customers who are most likely to benefit from Investment Pathways.

Investment Pathways can never of course be a substitute for regulated financial advice. But they are most certainly a step in the right direction in terms of helping non-advised customers make better decisions, and therefore reducing the risk of consumer detriment. As NMG Consulting concluded: "*Those who previously confessed to having their head in the sand told us that this was a positive first step, a relatable and simple way to make retirement choices feel tangible, with a focus on the outcome of each decision*".

Three aspects that may not be working quite so well for customers

The power of inertia

There is a step for customers prior to them considering Investment Pathways. And that includes deciding whether to remain invested in their current investments. The power of inertia – well evidenced by behavioural science – means that the forces at play will very likely give rise to a very high proportion of customers sticking with the investments they've currently got.

The consumer research conducted by NMG Consulting showed that 33% of prospective drawdown users will keep in the same fund(s) they've been in, with 25% moving into the fund provided by the relevant Investment Pathway (and with 11% picking new funds and with 30% don't knows). Evidence tends to show that "saying isn't doing" and so the 25% could very well be considerably lower in practice.

Ways should be explored of proactively prompting customers to consider Investment Pathways. Without such a nudge then inertia is likely to dominate. A straightforward way of implementing this could be to mandate the consideration of Investment Pathways alongside the existing fund(s) invested in (rather than positioning Investment Pathways as an alternative option to potentially think about). Such an approach

would need to be supported by appropriate guidance – and this is explored in more detail later in this response.

Giving Investment Pathways equal prominence

As if inertia were not enough, some product providers – in their marketing literature – seek to actively steer consumers away from Investment Pathways. Such an approach is particularly puzzling given that the FCA requires that the option to use Investment Pathways must be presented in the consumer journey with equal prominence to the other options (of keeping in the same fund(s) they've been in or picking new funds).

Investment solutions selected by product providers

In selecting investment solutions for each of the four Investment Pathways, product providers will have had to make an assumption about the risk profile of the customers expected to choose each one. With Investment Pathways being a relatively new concept, product providers will have had to have made assumptions based on the current evidence available to them.

There is existing evidence that the risk profile of customers accessing pension savings is quite different to when they were in the savings phase. Customers tend to be more risk averse when accessing pension savings. And the NMG Consulting research also found that "*risk looms large, with 15% describing themselves as 'very' risk averse*".

One of the four Investment Pathways covers income drawdown, and the NMG Consulting research found that this was the most popular Investment Pathway with it being chosen by 46% of prospective users. With these being non-advised customers it isn't possible to know quite how important this part of their pension savings is to them – some will have other separate generous pension provision (and possibly also other assets), while for others it will be their sole source of income in retirement over and above any State Pension. And that is why, as highlighted by the FCA, the focus must be on customers' capacity for loss – that is, customers' ability to take risk with their retirement income.

The investment solutions selected by product providers are of course in the public domain. On the face of it some appear quite high risk, almost as if product providers have just plugged in investment solutions which have been designed for the savings phase. And, looking provider-by-provider, there appears to be quite a bit of variability in the riskiness of comparable investment solutions. Analysis is not currently possible because the assumptions made by the product provider about the risk profile of the customers expected to choose each Investment Pathways are not yet in the public domain. IGCs have a duty to assess the appropriateness of the investment solutions selected and to report on this in their Annual Reports. So one hopes that, in the fullness of time, the extent to which product providers have selected investment solutions which are in the interests of customers can be subjected to appropriate scrutiny.

FCA Review in 2022

Investment Pathways are, in many ways, a new concept – not only for product providers but also from a regulatory perspective. And so, following their implementation in February 2021, there will doubtlessly be a lot to be learned from their application in practice.

It is therefore welcomed that the FCA has committed to a Post Implementation Review of Investment Pathways in 2022.

CUSTOMERS IN TRUST-BASED SCHEMES

The reality is that consumers are not in the main able to differentiate between contract- and trust-based schemes, and nor do they necessarily choose between the two or know which type they're in. As the protection they are afforded is not generally as a result of choice then reliance must be placed on the regulatory system.

In October 2018 the FCA and TPR launched their joint regulatory strategy. As per the press release, the strategy was "*aimed at strengthening their relationship, and taking joint action to deliver better outcomes for pension savers and those entering retirement*". The press release mentioned the ways in which the FCA and TPR would work together going forward including two new priority areas for joint action, the first of which was "*a strategic review of the entire consumer pensions journey – taking an in-depth look at what tools are needed to enable people to make considered decisions about their pensions*".

In order to reduce the risk of consumer detriment inherent in non-advised drawdown, the FCA pressed ahead with Investment Pathways. The FCA consulted on them twice, published a policy statement, and implemented them in February 2021.

What happened to the "joint action" trailed in the launch of the FCA/TPR strategy? Why is the consumer protection provided by the FCA's Investment Pathways not afforded to customers who are in trust-based schemes? DWP and TPR do not appear to have offered so much as an explanation as to why trust-based customers do not deserve similar protection.

The trade body for trust-based schemes, the PLSA, surveyed their members at their Investment Conference in March 2020 as to whether trust-based schemes offering drawdown should offer Investment Pathways. Only 10% answered "*No – they should be free to do something different*" (with 72% answering "*Yes – they should be required to offer Investment Pathways or explain why not*"; and 18% answering "*Yes – they should be required to*").

We met with the relevant policy team at DWP over a year ago, in April 2020, to express our concerns. The starting point must surely be consumers and ensuring that they are appropriately protected against the risk of detriment. We believe that the focus should be on good governance and on good outcomes – and most definitely not on whether a pension scheme happens to be either contract-based or trust-based. And so we said the introduction of broadly equivalent regulation on the trust-based side, in order to level the playing field, was both necessary and desirable. We explained that we thought it incumbent on TPR – given in particular their joint regulatory strategy with the FCA – to explain their thinking on this matter openly in order to help engender an informed discussion.

We followed up in writing a few days later. And, at the same time, we shared our concerns in writing with the relevant policy lead at TPR. We never heard back from DWP; or from TPR.

DWP and TPR must be encouraged to break their silence and explain what their plan for protecting consumers is and the reasons behind it. Given that consumers are likely to be oblivious as to whether they are in a contract- or trust-based pension scheme, why should they end up with very different experiences – and, importantly, different protections – depending on whether or not FCA regulation applies?

CUSTOMER COMMUNICATIONS ON INVESTMENT PATHWAYS

It is obvious that, having chosen an Investment Pathway, it is incumbent on the product provider to communicate to the customer the riskiness of the investment solution in a way that enables them to assess whether it is right for them.

Income in retirement

The primary purpose of pension savings is to provide customers with an income to sustain them through their retirement. And the research findings from NMG Consulting bear this out with 70% of prospective drawdown users saying that the Investment Pathway closest to their current needs is one which provides a long-term income – 46% "I plan to start taking money as a long-term income"; and 24% "I plan to use my money to set up a guaranteed income (annuity)".

In recent years 4% per annum withdrawals from a customer's pension pot has been extensively used as a rule-of-thumb for a level of sustainable income. But, in today's economic climate, 4% is considered by many to be high.

In this context the emerging data from the FCA published in September 2020 should be noted … https://www.fca.org.uk/data/retirement-income-market-data.

For customers with a pot size in excess of £100,000, the FCA data shows that for customers taking regular withdrawals – some 160,000 pension plans – 60% are taking 4% or more (with some 23% taking greater than 8%). There are many factors at play here. But it is a potential warning sign that in excess of 60% of customers with sizeable pots who are taking regular withdrawals are likely doing so at unsustainable rates.

Risk to consumers

As noted above, with these being non-advised customers, it isn't possible to know quite how important this part of their pension savings is to them – some will have other separate generous pension provision (and possibly also other assets), while for others it will be their sole source of income in retirement over and above any State Pension.

Therefore the single most important factor which needs to be taken into account when communicating risk to consumers is related to their ability to take risk with their income (which, in industry terminology, is often referred to as their capacity for loss). For the 70% of customers indicated by the research who need their pension savings to provide a long-term income, this means providing them with an indication of the likely level of sustainable income that they can take together with the risks associated with that (for example, what poor investment performance might mean to their retirement income).

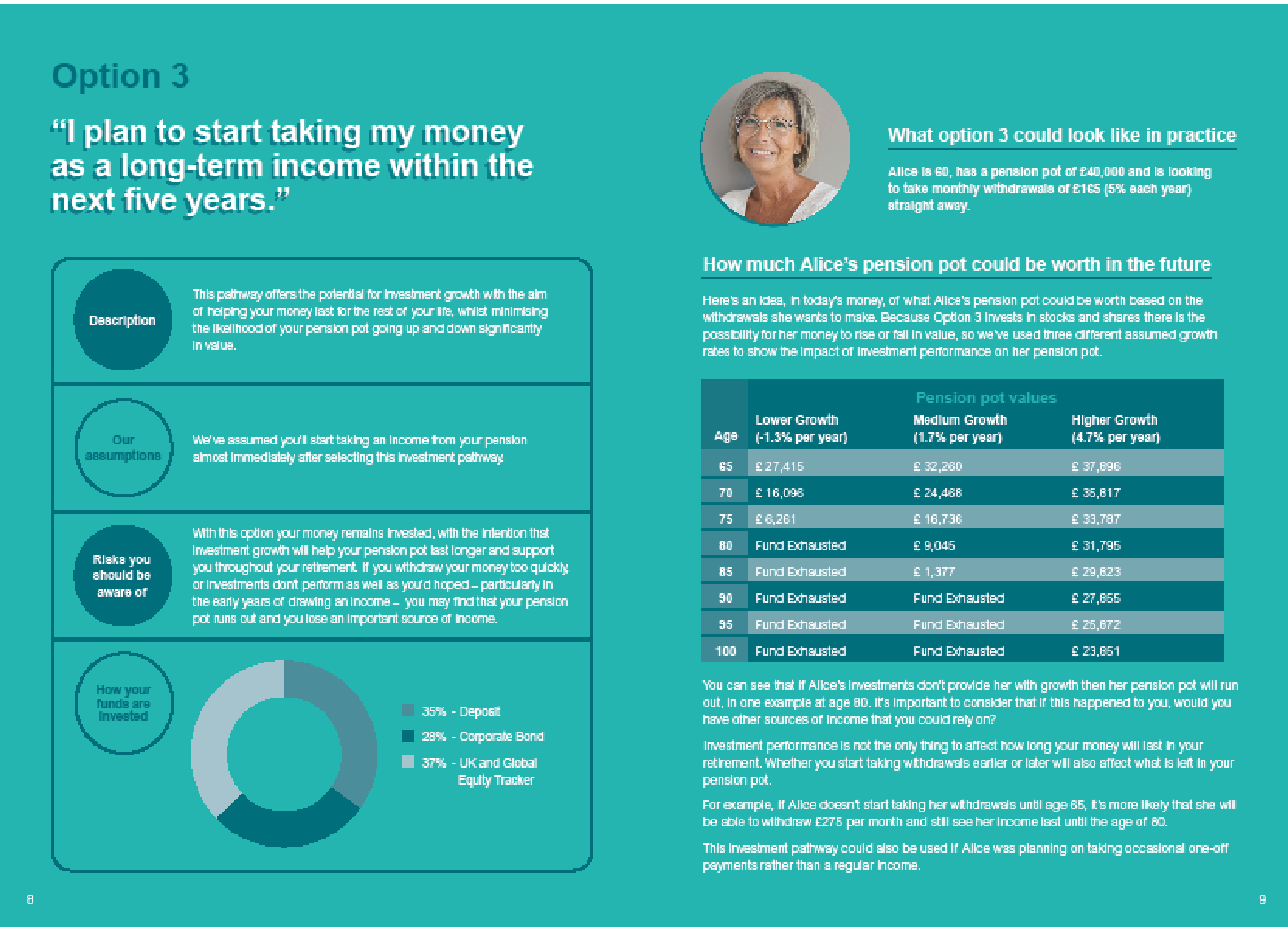
Such an approach is also fully supported by another finding from the research – which is that customers are very focused on outcomes and are far less comfortable with having to come to terms with the investment solutions which sit behind the Investment Pathways. It seems self-evident that, with customers having chosen an option to match their needs, that the risk would be described to them in terms of possible outcomes.

Customer communications – good practice

Communicating to customers the riskiness of the investment solution in a way that enables them to assess whether it is right for them is by no means straightforward. While it requires a thoughtful approach, it is certainly achievable. The initial research we have conducted indicates that the approach taken by ReAssure

represents good practice … https://www.reassure.co.uk/uploads/RE0472-220-0472-Investment-Pathways-Booklet.pdf.

By way of example, the option "I plan to start taking my money as a long-term income" indicates the likely sustainability were the customer to take withdrawals at 5%. In this way the customer is able to readily assess whether this level of risk is right for them.



Option 3

"I plan to start taking my money as a long-term income within the next five years."

Description – This pathway offers the potential for investment growth with the aim of helping your money last for the rest of your life, whilst minimising the likelihood of your pension pot going up and down significantly in value.

Our assumptions – We've assumed you'll start taking an income from your pension almost immediately after selecting this investment pathway.

Risks you should be aware of – With this option your money remains invested, with the intention that investment growth will help your pension pot last longer and support you throughout your retirement. If you withdraw your money too quickly or investments dont perform as well as you'd hoped – particularly in the early years of drawing an income – you may find that your pension pot runs out and you lose an important source of income.

How your funds are invested

8

What option 3 could look like in practice

Alice is 60, has a pension pot of £40,000 and is looking to take monthly withdrawals of £165 (5% each year) straight away.

How much Alice's pension pot could be worth in the future

Here's an idea, in today's money, of what Alice's pension pot could be worth based on the withdrawals she wants to make. Because Option 3 invests in stocks and shares there is the possibility for her money to rise or fall in value, so we've used three different assumed growth rates to show the impact of investment performance on her pension pot.

	Pension pot values		
Age	Lower Growth (-1.3% per year)	Medium Growth (1.7% per year)	Higher Growth (4.7% per year)
65	£ 27,415	£ 32,260	£ 37,696
70	£ 16,096	£ 24,468	£ 35,617
75	£ 6,261	£ 16,736	£ 33,787
80	Fund Exhausted	£ 9,045	£ 31,795
85	Fund Exhausted	£ 1,377	£ 29,623
90	Fund Exhausted	Fund Exhausted	£ 27,655
95	Fund Exhausted	Fund Exhausted	£ 25,672
100	Fund Exhausted	Fund Exhausted	£ 23,651

You can see that if Alice's investments don't provide her with growth then her pension pot will run out, in one example at age 80. It's important to consider that if this happened to you, would you have other sources of income that you could rely on?

Investment performance is not the only thing to affect how long your money will last in your retirement. Whether you start taking withdrawals earlier or later will also affect what is left in your pension pot.

For example, if Alice doesn't start taking her withdrawals until age 65, it's more likely that she will be able to withdraw £275 per month and still see her income last until the age of 80.

This investment pathway could also be used if Alice was planning on taking occasional one-off payments rather than a regular income.

9

There appear to be slightly in excess of 20 product providers which offer Investment Pathways, and the initial research we have conducted has focused on the 15 or so biggest such providers. Apart from ReAssure, only one or two other product providers appear to attempt to communicate the risks to consumers in this way. This is all very concerning.

Customer communication – poor practice

Based on the initial research, the vast majority of product providers base their communications to customers on the risk that the investment solution might fluctuate in value. Such an approach is largely meaningless as it fails to communicate to customers the riskiness of the investment solution in a way that enables them to assess whether it is right for them.

The approaches taken are much of a muchness. L&G is brought out as an example here, in part given the irony that it is the consumer research that they commissioned which found that customers are very focused on outcomes and are far less comfortable with having to come to terms with the investment solutions which sit behind the Investment Pathways … https://www.legalandgeneral.com/retirement/pension-drawdown.

The L&G equivalent to the ReAssure example above ("I plan to start taking my money as a long-term income") is simply a standard fund factsheet:

Non-UCITS Retail Scheme Key Investor Information

This document provides you with key investor information about this fund. It is not marketing material. The information is required by law to help you understand the nature and the risks of investing in this fund. You are advised to read it so you can make an informed decision about whether to invest.

Legal & General Multi-Index 4 Fund

Class I Accumulation - ISIN: GB00B88Y0217

The authorised fund manager of the Fund is Legal & General (Unit Trust Managers) Limited.

OBJECTIVES AND INVESTMENT POLICY

- The objective of the Fund is to provide a combination of growth and income and to keep the Fund within a pre-determined risk profile. The Fund's potential gains and losses are likely to be limited by the objective to stay within its particular risk profile.
- The Fund is part of a range of risk profiled funds. The target risk profile for the Fund is set by an independent agency*, and is based on the historic return and volatility of different asset types. The risk profile ranges from 1-10 with 1 being the least risky, and 10 being the most. This Fund aims to stay within risk profile 4. We use our experience and research, together with research and allocation guidelines from this independent agency* to restrict the types of assets held and the allocation of each asset type to stay within the target risk profile.
- The Fund will have exposure to company and government bonds (a type of loan that pays interest), shares in companies, money market instruments (a form of loan that pays interest and is designed to have a stable value), deposits, cash and indirectly to alternative asset classes (such as commodities) and property. The Fund will typically have higher exposure to bonds, money market instruments and cash than to shares in companies relative to other funds in the Legal & General Multi-Index Fund range with a higher risk profile. However, the aggregate exposure to shares in companies may still be material.
- The bonds the Fund is exposed to may be investment grade (rated as lower risk) or sub-investment grade (rated as higher risk). Investment and sub-investment grade bonds are bonds that have been given a credit rating by a rating agency. Credit ratings give an indication of how likely it is that the issuer of a bond will be able to pay back interest and the loan on time.
- In order to achieve this exposure, at least 75% of the Fund will be invested in collective investment schemes. At least 50% of the Fund will be invested in index-tracker schemes which are operated by Legal & General.
- The Fund may also invest directly in shares in companies, bonds (both government and non-government), money market instruments (such as treasury bills), cash and deposits.
- The Fund may use derivatives (contracts which have a value linked to the price of another asset) to:
  - reduce risk or cost; or
  - generate additional capital or income with no, or an acceptably low, level of risk.

Other Information:

- The Fund is actively managed as the Manager uses their expertise to pick investments to achieve the Fund's objective.
- There is no benchmark available for this Fund as it is constrained by its objective to remain within its risk profile.
- Your units will be accumulation units. Income from the Fund's investments (dividends) will be reinvested back into the value of your units.
- You can buy or sell units in this Fund on any business day. You need to contact us with your instruction before 3.00pm. This is the time we calculate unit prices for this Fund. If you contact us after 3.00pm, the units will be bought or sold at the next business day's price.
- The Fund's base currency is denominated in sterling (British pounds).
- This Fund is primarily designed for investors:
  - who have received advice and had their attitude to risk assessed and matched to the risk profile of this Fund but may be appropriate for those investors who have considered the risk profile of this Fund with the others in the Multi-Index range;
  - who are looking for growth and income from an investment in bonds, shares in companies, money market instruments, deposits, cash and indirectly to alternative asset classes (such as commodities) and property.
- Although investors can take their money out at any time, this Fund may not be appropriate for those who plan to withdraw their money within five years.
- This Fund is not designed for investors who cannot afford more than a minimal loss of their investment.
- To help you understand this Fund, its risk profile and how it compares to others in the range we have created a guide www.legalandgeneral.com/mi-guide.
- We recommend you read our guide to the Fund range to help you decide if this is the right fund for you.

RISK AND REWARD PROFILE

Lower risk ← → Higher risk

Potentially lower rewards ← → Potentially higher rewards

1	2	3	**4**	5	6	7

- The Risk and Reward Indicator table demonstrates where the Fund ranks in terms of its potential risk and reward. The higher the rank the greater the potential reward but the greater the risk of losing money. It is not guaranteed to remain the same and may change over time. It is based on historical data and may not be a reliable indication of the future risk profile of the Fund. The shaded area in the table above shows the Fund's ranking on the Risk and Reward Indicator.
- The Fund is in category 4 because the mix of different asset types in which the Fund invests has a balancing effect on the rate at which the Fund share price moves up and down. This type of fund is generally considered to be higher risk than one investing only in bonds and lower risk than one existing only in company shares.
- Even a fund in the lowest category is not a risk free investment.
- The value of your investment may fall as well as rise and is not guaranteed. You might get back less than you invest.

Further information on the risks of investing in this fund is contained in the Prospectus available at www.legalandgeneral.com/reports.

The risk and reward indicator may not take account of the following risks of investing in the Fund:

- The Fund could lose money if any institutions providing services such as acting as counterparty to derivatives or other instruments, becomes unwilling or unable to meet its obligations to the Fund.
- By investing in other funds this Fund indirectly holds bonds and property that are traded through agents, brokers or investment banks or directly between buyers and sellers. This makes them less easy to buy and sell than investments traded on an exchange. In exceptional circumstances the Fund may not be able to sell its holdings in other funds and may defer withdrawals, or suspend dealing. The Directors can only delay paying out if it is in the interests of all investors and with the permission of the Fund depositary.
- The Fund invests directly or indirectly in bonds which are issued by companies or governments. If these companies or governments experience financial difficulty, they may be unable to pay back some or all of the interest, original investment or other payments that they owe. If this happens, the value of the Fund may fall.
- Investment returns on bonds are sensitive to trends in interest rate movements. Such changes will affect the value of your investment.
- Derivatives are highly sensitive to changes in the value of the asset on which they are based and can increase the size of losses and gains.
- The Fund may have underlying investments that are valued in currencies that are different from GBP. Exchange rate fluctuations will impact the value of your investment. Currency hedging techniques may be applied to reduce this impact but may not entirely eliminate it.

*** The Fund targets risk profile 4 as calculated by Distribution Technology ("DT").They are an independent agency who provide risk profiling tools to advisers and fund managers.**

The Risk and Reward profile scale above is calculated differently to the DT Risk Profiles. The DT profiles range from 1 to 10 with 10 being the highest (rather than a scale of 1 to 7 for the Risk and Reward profile).

Regulatory context

As noted the approach most product providers have taken is of describing investment volatility and largely ignoring the particular outcome that the customer has chosen.

The fact that these approaches do not appear to be focused on the needs of customers is especially baffling in light of the regulatory backdrop.

FCA rules require that product providers must: "*describe to the retail client, using plain language, the level of riskiness of each pathway investment*". And the FCA has set out their expectations very clearly: "*We do not want consumers to select a pathway solution if the risk profile of the solution does not match their attitude to, or capacity for, risk. Providers must describe the riskiness of each investment solution that they offer, to enable consumers to make this assessment*".

And, in order to provide an extra layer of governance, the FCA has also imposed a duty on IGCs with regard to Investment Pathways. FCA rules require IGCs to assess "*whether the communications to pathway investors are fit for purpose and properly take into account the pathway investors' characteristics, needs and objectives*".

FCA Review in 2022

When it comes to communicating risk, the FCA's review in 2022 cannot come soon enough from a consumer perspective. Things do not appear to be working quite as intended.

ANNUITIES HAVE A PART TO PLAY

Annuities are certainly of appeal in principle to many consumers. The research findings from NMG Consulting show 24% of prospective drawdown users saying that the Investment Pathway closest to their current needs is "I plan to use my money to set up a guaranteed income (annuity)".

Pension drawdown calculators are common place in the market to support the consideration of income drawdown as an alternative to an annuity. These calculators are positioned as helping consumers to decide what income withdrawals might be sustainable, and to see how different growth rates and life expectancies could affect how long the pension lasts.

In using growth rates to project income in retirement, a number of product providers appear to be using the FCA's intermediate illustration rate of 5% pa as if it were a realistic assumption. This means that they are showing to customers that, even after a charge of 1% pa is applied, they can take withdrawals for life at 4% pa with all their capital still remaining intact. Or, put another way, if the capital is to be also used to fund withdrawals over expected life expectancy, then a 60 year old male can take withdrawals in excess of 6% pa.

In the current and foreseeable investment environment, the forecasts produced using the FCA illustration rates seem very optimistic. Consequently, comparisons of drawdown with annuities make annuity purchase seem economically very unattractive. This represents product bias in favour of drawdown over annuities.

The basis for the FCA illustration rates was last updated in 2014 when investment market conditions were very different to what they are today, and long before drawdown became a mass market retirement income product. In 2014 the 15-year par yield, for example, was in excess of 3% while early in 2021 it was only 0.5%.

Therefore the use of the FCA illustration rates today for producing income projections for drawdown must be questioned.

In using the FCA illustration rates, there is a requirement on product providers to ensure that the rate is realistic – the intermediate rate is a maximum and it must accurately reflect the investment potential of the underlying investment options. However, product providers appear to think that they can avoid criticism by relying on the FCA illustration rates – and are maybe avoiding asking themselves the more difficult question as to whether the FCA rates are suitable for the purpose. There is perhaps the opportunity for the FCA to remind product providers of their responsibilities in this area – and also clarify whether or not they believe that illustration rates are a reasonable basis for setting income levels for drawdown and in evaluating the relative attractions of drawdown and annuities.

GUIDANCE

The case has been made above that the majority of product providers have produced customer communications which represent poor practice. However, even were the communications to be much improved, many consumers will still want the reassurance that they are making the right choice for them personally. They might contact their product provider or Pension Wise.

Behavioural science provides evidence that giving people clear recommendations, and motivation for acting, is extremely helpful when making financial decisions. This is the case when switching investments – for example from the fund which is currently invested in to an Investment Pathway – because people avoid situations where they risk losing money and might feel bad about their decision. As a result many people avoid making a decision as they anticipate they might regret it.

Consumers do not want to be told 'on the one hand this, on the other hand that, go figure'. Consumers want to be reassured that they are making the right decision for them personally.

It is therefore imperative that the so-called boundary between 'guidance' and 'advice' is fully explored from the consumer perspective. The system should be designed so that it delivers what consumers want and need – and that is advice in the dictionary sense of the word, namely a recommended course of action.

CONCLUSIONS

- Investment Pathways are a force for good, and the learnings from their use in practice should be used to refine and further develop their effectiveness for consumers.
- The consumer protection provided by Investment Pathways to customers in contract-based schemes should also be afforded to customers who are in trust-based schemes.
- The standard of customer communication on Investment Pathways should be significantly improved by product providers so that customers can better assess the riskiness of the investment solution offered and therefore whether it is right for them.
- Any product bias in the market that exists in favour of drawdown over annuities should be removed.
- Guidance services should be developed such that consumers are given the reassurance that they are making the right choice for them personally.

May 2021