Retirement income provision in a post-pension freedoms world

Platforum

ABOUT PLATFORUM

Platforum is a research and consultancy company analysing trends in retail investment distribution. Our work covers the wealth management, advice and direct-to-consumer markets across the UK and Europe. We also work with adviser firms, helping with their platform selection and due diligence.

We are a strategic partner for asset managers, platforms, banks, insurance companies and technology providers. For more than a decade we've been helping our clients to understand how the landscape is evolving.

Our ongoing research is delivered via reports, live events, face-to-face briefings and webinars. We also carry out bespoke consultancy work supporting clients' marketing, sales and strategy.

JUST

Just commissioned Platforum to produce this research paper to look at post-retirement financial advice and how income guarantees can be implemented in clients' post-retirement portfolios.

Just has launched a Secure Lifetime Income (SLI) solution, which sits within a drawdown wrapper on-platform. By isolating guaranteed annuity income from income withdrawn from the pension, the product addresses some of the risks of decumulation whilst taking advantage of flexibility afforded by platforms and preserving the tax efficiency of the pension.

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FOREWORD

Adrian Boulding, Chair, Spire Platform Solutions

Some of the greatest military Generals of the past – Julius Caesar, Alexander the Great and Hernan Cortes – famously burned their boats as soon as their invading armies had disembarked on the beach. Despite facing an uncertain outcome, they did this as a psychological play to ensure that their followers contemplated nothing other than a successful campaign ahead.

And in many ways a similar sense of "no going back" is felt by everyone today as they cross the threshold from working life to retired life. Giving up the big job, working 9 till 5 in a career that has climbed the ladder of employment, means giving up the big regular income it brought every month. Whilst many may take part-time employment in the early years of retirement, it's almost impossible to reclaim the peaks held previously. Looking ahead, those entering, or already in, retirement face a cruel dilemma. If they consume their savings too slowly, they may not have the opportunity to catch up.

Conversely, consume savings too fast and the later years of retirement will be unfulfilled.

Financial advisers have a key role to help clients navigate retirement successfully – and they should use all the modern tools and techniques at their disposal to do so. A well-thought-out financial plan can give pensioners the confidence to enjoy retirement to the full without worrying about the dangers of stock market collapse or living too long.

Very often the best plans in life deploy more than one strategy to achieve their goal. And it was this desire to support blending that was the driver behind Just's decision to develop the Secure Lifetime Income product. Its creators sought to work with the way that financial advisers work today – everything on-platform, and portfolios regularly reviewed and re-balanced in line with client's individual needs.

In this final stage of life more than any other, fulfilling the client's ambitions should determine the financial strategy and not the other way round. Money and assets should be subservient, deployed to support the achievement of life's remaining goals. The latest stochastic techniques can show the confidence level attaching to the declared goals, both at outset and at regular reviews.

Flexibility will be crucial to success in a retired lifetime that may span many decades. Whilst some aspects of retirement income may be advisedly anchored firmly down, other assets need to remain capable of redeployment, able to react as both client's and external circumstances change.

There are no easy answers in retirement and the right answer will be different for everyone. But if an adviser can help a client find the right blend of short-term tactical opportunities and long-term strategic priorities for their risk tolerance, then they have a map that can chart the course for a fulfilling retirement. That has the makings for a happy client and a quietly contented regulator.

EXECUTIVE SUMMARY

Our research finds that too many advisers are exposing themselves to significant risks through their post-retirement advice processes:

- The risk of living too long is often under-estimated by both clients and advisers – especially when they use average longevity estimates for planning how long a client's money will need to last rather than using much longer realistic timescales. Half the population will live longer than the median by definition. Many advised clients, who are typically much richer than the average person, will live significantly longer. Even an adviser who selected 95 years as the basis for estimating a 65-year-old client's lifetime income would be in danger of leaving them with an inadequate income in roughly a fifth of all cases. In most cases, advisers should project clients' lifetimes to age 105 years or later.
- Advisers are typically recommending post-retirement portfolios based on pre-retirement practices. Risk tolerance rather than capacity for loss tends to drive the asset allocation process.
- Annuities have become more expensive than they were, but their guarantees can still provide value for money – they simply reflect the higher levels of assets now needed sustain a longer retirement. Annuity rates have also fallen because of reduced yields on fixed income investments, which are the same low-yielding investments that are also being used in multi-asset portfolios.
- Some advisers might consider that clients with £1m+ are too wealthy to require a secure income, but that would be a simplistic assumption that omits the possible impact of such key variables as spending patterns, desire to make lifetime gifts, inflation and disappointing investment performance over the long term. With a combination of overspending and adverse investment markets, such clients could easily find themselves outliving their assets in a 30-year plus retirement.
- Anecdotal evidence from our interviews suggests that plenty of advisers do not fully grasp the concept of capacity for loss and many do not assess it appropriately, especially in the context of pension income drawdown. Its integration into clients' risk profile is often haphazard. The process of reconciling a client's psychological risk tolerance with their more objectively derived capacity for loss is normally left to the adviser's judgement.
- Few advisers have yet read across from the FCA's requirements about DB transfers (e.g. in the recently published Defined Benefit Advice Assessment Tool – DBAAT) to the parallel issue of DC pension income drawdown and specifically to the need to assess clients' attitude to guaranteed lifetime income balanced against their wish for flexible benefits. We think that wider understanding and acceptance of the regulator's approach to pension income drawdown would lead to significantly more recommendations by advisers for clients to purchase annuity products.
- Long-term cashflow modelling is varied in how it is practised in the adviser community and there is considerable room for greater standardisation to make the process more valid and useful and to employ it as the central tool for measuring capacity for loss.
- In particular, we find the continuing prevalence of deterministic rather than stochastic cashflow modelling, which downplays the risks of clients running out of money in retirement. Deterministic modelling fails to demonstrate the probabilities of outcomes, making it more difficult for advisers and their clients to assess of the robustness of their choices. This undervalues the benefits of purchasing secure income/annuities. We think that the appropriate use of stochastic cashflow modelling should be central to advisers' assessment of recommendations for less risky pension drawdown.

Retirement market of the future

- Advisers should review their risk profiling processes to make sure that they are appropriate for circumstances in which predictable income is typically even more important than capital security. Advisers also need to think more carefully about layering and prioritisation of expenditure needs and therefore income flows.
- We are already seeing a rise in use of cashflow modelling of income and expenditure, which is increasingly embedded in post-retirement planning, especially in its role in assessing capacity for loss. Generating and securing income are generally of greater importance post-retirement than in the accumulation phase.
- Advisers need to consider how they present annuities to clients in a balanced way so that they understand the trade-offs between flexibility and certainty, the risks of not annuitising and the diversification benefits of annuities. Annuities are not poor value in comparison with the alternative investment solutions – they just look expensive compared with the past. We recognise the difficulties with clients who may like the characteristics of annuities but do not want to buy the product. A similar issue arises with DB transfers.
- Projected withdrawal rates should be based on realistic assumptions and greater use of stochastic modelling of outcomes. One reason why advisers are not recommending annuity-type products is that they often overestimate the sustainable withdrawal levels that clients can safely take from their portfolios and they underestimate the degree of risk involved in taking withdrawals of capital and income.
- Advisers should develop a clearer methodology for integrating risk tolerance and capacity for loss to create a score. Arguably, any negative capacity for loss considerations should normally outweigh clients' more optimistic attitudes. There need to be standard processes and methods of measuring capacity for loss in the context of investing for income in retirement and they should be based on the use of cash flow modelling.
- There may be a case for the regulator to publish explicit guidance about drawdown and annuity purchase along the lines of COBS 9.22R (2), which requires advisers to ascertain clients' attitude to transfer risk in the context of transfers out of defined benefit pensions. This is the client's behavioural and emotional response to giving up guaranteed benefits for those that are flexible and not guaranteed.
- We expect to see greater use of stochastic modelling to demonstrate the risk that longevity poses for retirement portfolios. We are also starting to see some innovation in terms of quantifying capacity for loss, with providers such as EV (formerly EValue) looking at tools that assess the robustness of portfolios. Tools like these often demonstrate the efficacy of securing a proportion of a client's income.

INTRODUCTION

The “nastiest, hardest problem in finance” is how the Nobel Laureate economist William Sharpe described the challenge of securing a lasting retirement income. It is therefore perhaps not surprising that the UK market is still evolving its approach and solutions. Just is one of the companies innovating in this area, and has commissioned this research to look at financial advisers’ post-retirement advice and how secure income can fit within clients’ portfolios.

Post-retirement planning is ripe for further development. Portfolio design for retirement income currently centres on a singularly one-dimensional approach to risk – clients’ psychological ability to tolerate ups and downs in the value for their investments and to some extent an assessment of their ability to cope with capital losses. This is fine as far as it goes but it doesn’t go far enough. Stability of income is more important than capital security – especially to meet non discretionary spending needs; longevity issues are key, especially for clients who live ‘too long’; average investment returns are hard to predict but their pattern can be crucial.

We’re seeing risks in advisers’ retirement processes: underestimating longevity, insufficient evaluation of clients’ attitude to pension drawdown risk, and the use of deterministic rather than stochastic modelling. Ultimately, the cost of providing income for life is significantly higher than many people assume.

We expect to see the use of cashflow modelling become even more central to retirement planning, but we think it needs to be done much more effectively. Advisers and clients need to layer their priorities for their income needs into various categories of essential and nice to have.

Just has introduced an annuity product – the Secure Lifetime Income – that goes some way towards solving aspects of this problem. The product can be used for a segment of a client’s portfolio, underpinning non-discretionary income, whilst maintaining some of the flexibilities afforded by drawdown on-platform. The purpose of the white paper is to look at retirement and trends in the retirement market to consider advisers’ use of the SLI product, the barriers to its adoption and what changes in practice might lead to its more widespread recommendation and uptake where appropriate.

Annuities have got a bad rap of late. Following pension freedoms they look inflexible (although somewhat mitigated in the case of SLI). Rates are low, which should be a warning that providing an income for life is simply very expensive. But ultimately, they benefit from risk pooling; without which, clients and their advisers are assuming the risks of shortfalls.

Methodology

This research sought the opinions of ten financial advisers in a depth interview setting. The sample consisted of a mix of SLI users and advisers who were neutral or agnostic to the concept.

Further research was conducted in three group interviews where three advisers debated the pros and cons of the SLI concept against the background of current retirement solutions.

The research also builds on previous Platforum research, including a survey of 154 individuals working in advice firms undertaken in December 2019 and January 2020, a roundtable discussion with eight advisers in February and further phone interviews of ten advisers.

The following brief description of the SLI product was used in the research interviews.

The SLI proposition

Secure Lifetime Income (SLI) is an annuity solution from Just specifically designed to sit alongside and play a supporting role to invested assets within a drawdown wrapper. The guaranteed lifetime income generated by SLI complements the characteristics of the invested portfolio enabling the client to benefit from both guaranteed lifetime income and retain market exposure within a single arrangement.

SLI, which is currently available via the Novia platform, comes with some unique features designed to address perceived shortcomings of traditional annuities:

- Initial death benefit of 75% of its purchase price.
- A cash-in option.

These features, when combined with the increased flexibility gained by being operated within a drawdown wrapper, creates a package that is able to deliver an array of client needs.

The benefits for clients

- The security of a fixed and guaranteed lifetime income.
- A higher initial sustainable income than could be safely taken in drawdown from the same level of capital.
- The probability of elevated long-term returns from:
  - Reduced sequence risk and volatility drag.
  - Mortality cross subsidy.
  - Total lack of correlation with equities – unlike bonds.
  - Investment in corporate bonds with 100% FSCS underpin – so no credit risk.
  - The scope to increase the client's overall asset allocation to equities for greater long-term growth.

Example – SLI provides a better chance of ensuring discretionary and non-discretionary income is maintained[1]

- Male average health (non smoker) age 65 needing:
  - Non discretionary income £5,000.
  - Discretionary income £12,500.
  - Pension drawdown fund £500,000.
- Assumptions:
  - Advice fee 0.5%/Platform fee 0.25%/Investment Management fees 1%.
  - Balanced portfolio/risk profile.
- Two Scenarios:
  - Invest all £500,000 in a balanced portfolio.
  - Use SLI to secure the £5,000 p.a. of non-discretionary income, remainder invested in the balanced portfolio.

Age at death	Chances of reaching age	Chances of achieving income – no SLI		Chances of achieving income – with SLI	
		Non discretionary	Total	Non discretionary	Total
91	50%	97%	92%	100%	96%
95	25%	93%	87%	100%	91%
99	10%	88%	81%	100%	87%

[1] Source: Just stochastic projections, SLI rates and investment assumptions correct as at 15 October 2020.

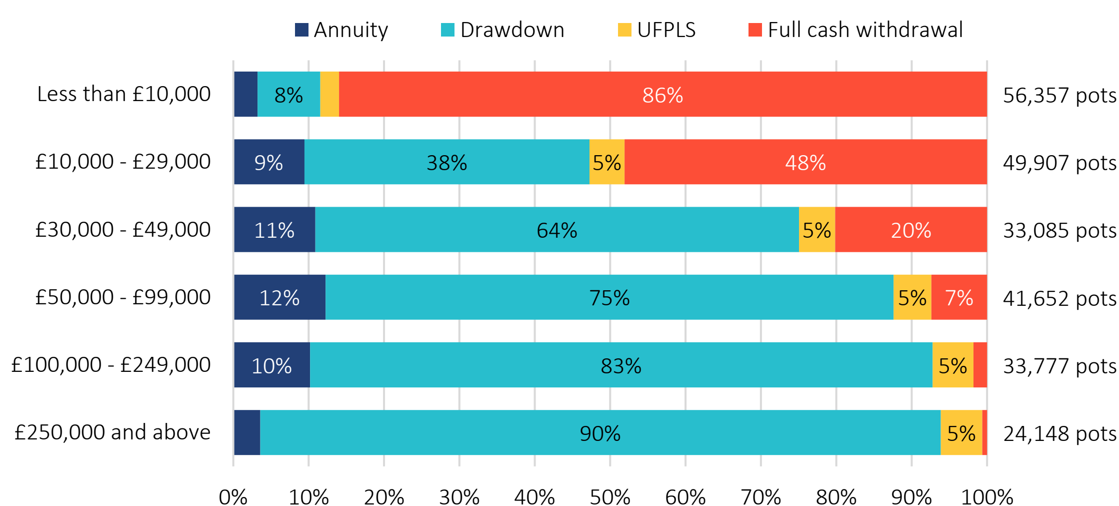
1 CURRENT POST-RETIREMENT ADVICE

The introduction of pension freedoms in 2015 was perhaps the single biggest development – legislative or otherwise – to affect the retirement market in the UK for at least a generation. Roughly 13 million individuals are currently retired, according to the latest ONS data.[2]

The current structure of the drawdown market is just six years old. The pre-2015 regime allowed drawdown, but carried heavy restrictions – investors were either limited in the amounts they could draw, or needed to have other secure core income from such sources as their state or defined benefit pension or a lifetime annuity.

With pension freedoms, these constraints disappeared and it was suddenly a free-for-all. Most advisers and their clients quickly forgot the idea of needing a core income. Levels of annuity purchase dived and became largely confined to clients with relatively small pension pots who wanted an income and those with a very low appetite for risk. Drawdown became the almost universally preferred solution.

Figure 1: Pension pots accessed with use of regulated advice – by pot size



Source: Retirement Income Market Data, FCA, September 2019

Simultaneously in 2015, post-retirement defined contribution pension death benefits became effectively free of inheritance tax. For higher net wealth clients this change transformed DC pensions from retirement income products into IHT mitigation solutions that should be accessed after running down most other financial resources.

"Lots of our clients have enough other assets, so their pension retirement pot is, in the current environment, becoming an IHT pot. Or it might be a pot to be accessed for topping up their needs and providing for extras in their lifestyle, rather what they originally saved it for, which was to provide the substantial income for them."

The advised retirement planning market – like the regulator – was taken by surprise and the consensus for dealing with retirement income issues is continuing to evolve with a range of processes and solutions.

Lessons for providers, advisers and regulators are available from US, Australia and other markets but the circumstances are different in important respects. Many of the techniques and approaches have been developed in these markets or they are derived from those that have worked well in the accumulation market. The idea that the processes and solutions for decumulation should be different for accumulation is still not universally accepted.

In this chapter we will cover some of the background to post-retirement advice, how advisers are 'planning' clients' retirement and the investment strategies they are currently implementing.

[2] *Pensioners' Income Series*, Department for Work and Pensions, March 2019

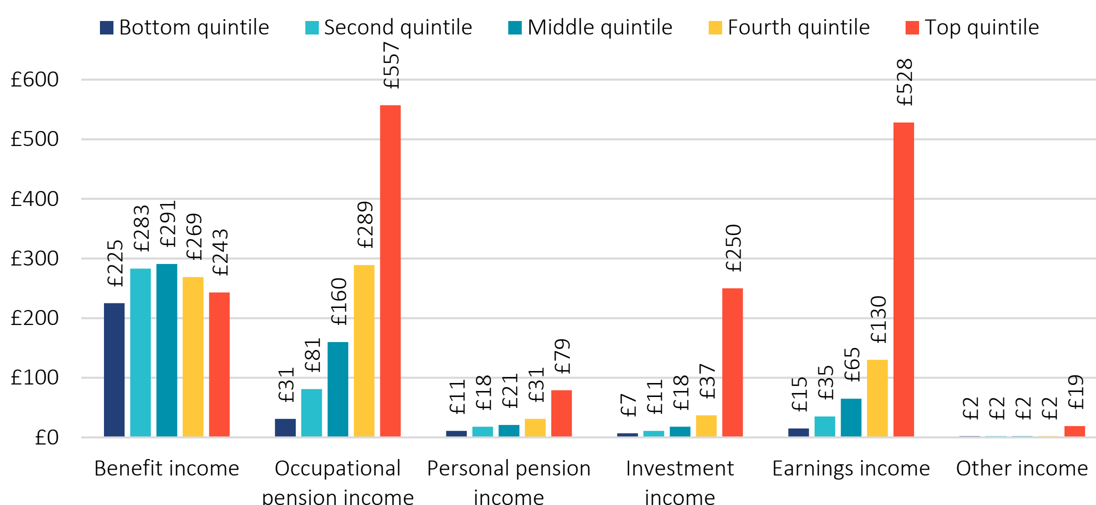
1.1 Background to developments in retirement planning

Major social and economic changes have contributed to the changing retirement income landscape, including:

- The declining availability of DB pensions, which have historically underpinned retirement planning for many. The top quintile will start to resemble the rest of the population in this respect as fewer qualify for these types of benefits.
- The growing flexibility of retirement, with increasing numbers of people continuing to work after starting to withdraw their pensions.
- Intergenerational planning: the increasing need for older clients to provide for 'generation rent' with lifetime gifts – questions of affordability and need to secure long-term retirement income. Wealthy clients and their children with assets to spare may increasingly expect advisers to solve the problems of maximising transfers to younger generations while preserving their own long-term security of income.
- The decline in nominal interest rates depressing safe rates of return from deposits and annuities. This has affected investment returns generally.
- Rising longevity of pensioners – the risk of living too long is often under-estimated by both clients and advisers – especially using average longevity estimates for planning timescales. Annuities have become more expensive, but so have the levels of assets needed sustain a long retirement.
- The dramatic decline of annuity purchases: small pension pots are often withdrawn fully as cash; and large pots are typically moved into drawdown, especially when financial advice in involved.

The retirement income market is polarised between the top quintile – from which advisers typically draw their clientele – and the rest. Substantially more DB and other reliable income is available to the top quintile as is shown in Figure 2.

Figure 2: Average weekly retirement income (pensioner couples) – by overall earnings



Source: Pensioners' Income Series, Department for Work and Pensions, March 2019

1.2 Planning retirement incomes

We find that financial advisers are still adapting to pension freedoms. Financial planning is becoming more focused on post-retirement advice and investment propositions are developing to meet the specific needs of decumulation, such as combating sequence and longevity risks.

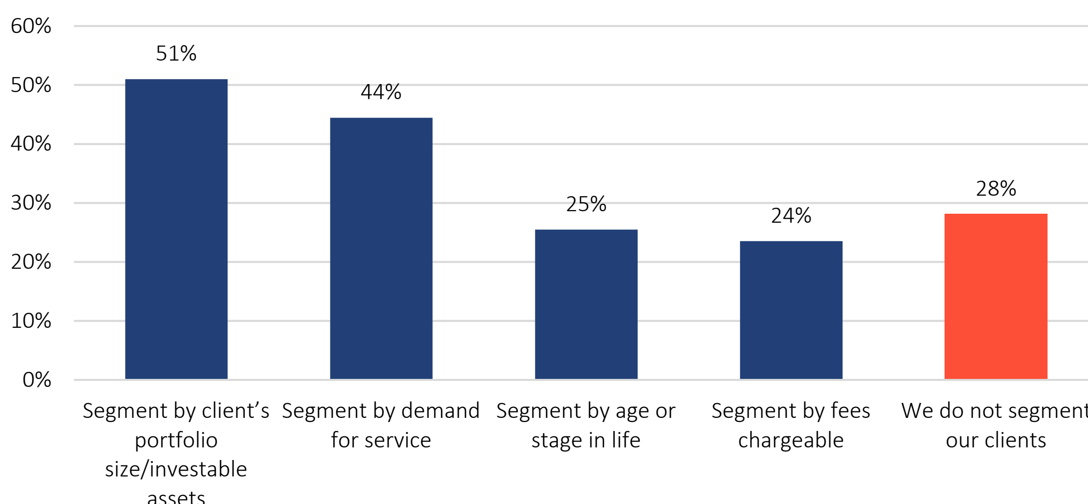
However, the starting point for advice firms has been their traditional focus of building and preserving clients' capital. Most of the tools used by advisers are therefore focused on where and how capital is invested, rather than how to use it most effectively to generate income.

In this section we look at aspects of the financial planning process and how they are being adapted for post-retirement planning.

1.2.1 Client segmentation

Client segmentation is not used much when considering default planning strategies – at least not in a centralised and organised way as envisaged by PROD. Instead, advisers mostly undertake segmentation according to value of portfolios and level of fees rather than other more planning-related characteristics.

Figure 3: How advisers segment their clients



Source: Platforum, January 2020
Which of the following methods does your firm/you use to segment your clients?
Base: 153 advisers

Despite this lack of formal segmentation, advisers report on several distinct client characteristics whose circumstances, aims and objectives affect the proposed solutions and in particular clients' needs or desires for a secure lifetime income.

Pension funds as inheritance tax planning vehicles

A significant proportion of advisers' clients regard their DC pension as primarily an inheritance tax mitigation plan and they are not likely to be candidates for SLI purchase, unless they suffer a major change in their circumstances. These clients have substantial wealth in the form of capital and/or secure income in relation to their own personal expenditure.

"To be perfectly honest, 95% of my clients have got enough money to last them and we're actually spending more time encouraging them to spend more."

- Passing assets down to the next generation and inheritance tax mitigation are high priorities for clients who generally regard their DC pension fund as an IHT plan rather than a source of income (except in extremis). They are unlikely to be candidates to buy pension annuities, unless they have depleted their estates so much during their lifetimes, by lifetime transfers to younger generations, that taking income from their pensions becomes at least a theoretical possibility.

  "We're seeing a lot more clients wanting to do things to help their kids. They're seeing the generational unfairness becoming a bit more apparent. I'm seeing more and more clients who want to do more for their kids and grandkids."

- These higher net worth clients typically have substantial ISAs and General Investment Accounts (GIAs) from which they might draw income and capital as required. On the basis that they might need a secure lifetime income financed from a GIA, they might theoretically be candidates for a purchased life annuity (with effectively tax-free income and bought out of the taxable estate) at some stage, although this product is seldom used nowadays and rates are typically less competitive than for pension annuities.

Drawing on non-pension assets before accessing pension assets

Many clients have most of their invested assets in pensions with some other investments in ISAs and usually to a lesser extent in general investment accounts (GIA). Such clients may be candidates for investing in the SLI at some stage – potentially a good few years into their retirement.

Advisers tend to encourage these clients to draw on their non-pension assets and pension commencement lump sum (tax free cash) first. Only after this has been largely used up would they be advised to start drawing on their remaining pension fund. Nevertheless, the adviser's strategy would be to retain the inheritance tax-free pension fund as long as possible in case of their premature death.

The funds might also be regarded as reserves to be used in the event of a need for long-term care – which might arise for about a fifth of clients. These clients would be possible candidates for annuity-type products – but only after a few years from the start of their retirement.

Drawing on the pension for income from the start

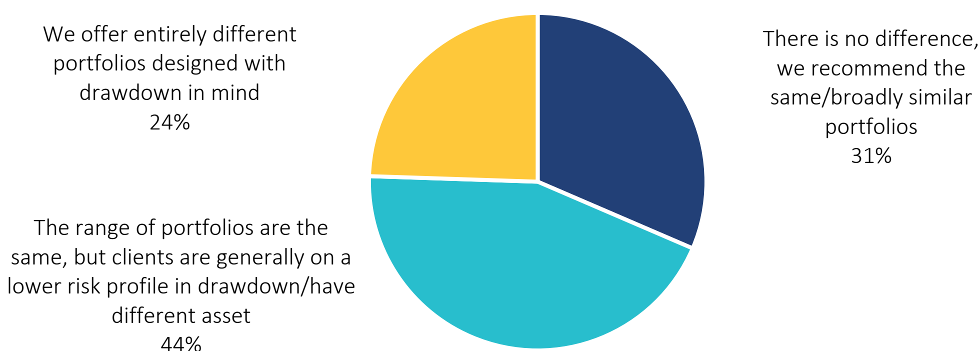
A large section of the population is likely to depend on their pension fund as a source of income from early in their retirement. In most cases this is because they do not have many other financial resources and they would therefore be candidates for products that provide guaranteed income.

"We've seen people who are in drawdown when they should never be in drawdown. From our businesses' point of view we would look at annuity rates and things like this [SLI]. We would tend to look more at lifetime type annuities."

1.2.2 Risk tolerance

Advisers are increasingly approaching the process of planning at- and in-retirement differently from the process of planning for accumulation. But there are many who do not differentiate between the planning processes. Advisers generally recognise additional risks of drawdown in the form of sequence risk and pound cost ravaging, although this does not necessarily carry through to making major adaptations to accumulation-based portfolios. Once someone has retired, it is generally harder to return to employment; so the opportunities become fewer for investors to work longer or harder to rebuild a portfolio that has sustained losses – as they might have done when they were younger.

Figure 4: How drawdown portfolios differ from accumulation portfolios



Source: Platforum, January 2020
How do your recommendations for the portfolios for your clients in drawdown differ from those for clients in accumulation?
Base: 143 advisers

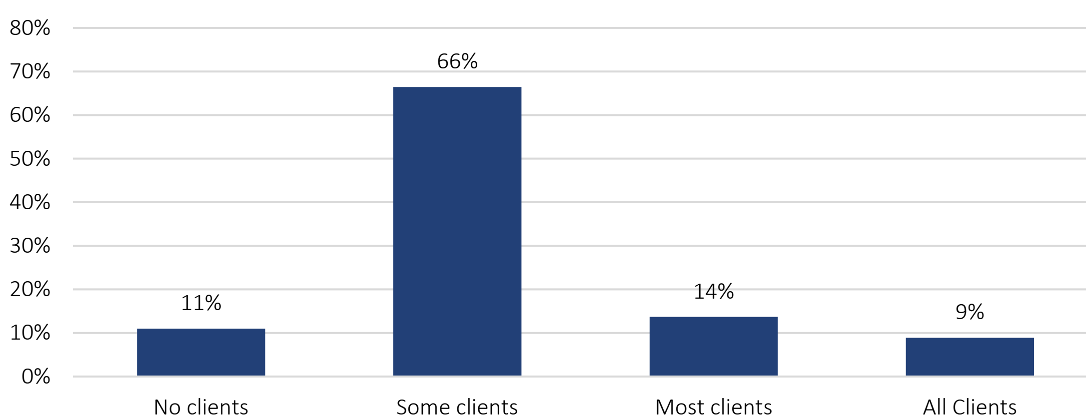
Risk tolerance assessment is more or less universal, although advisers undertake the process using a variety of approaches and tools. It seldom involves talking about the importance of income as such.

Asset allocation by the adviser is generally based on the client's risk profile. It might be a direct outcome of the risk profiling tool like Finametrica, but it may be informally adjusted after discussion.

The vast majority (89%) of advisers say their clients change their risk profile in retirement (Figure 5). It is therefore arguably an anomaly that drawdown portfolios are made up of the same components as accumulation portfolios, even though they are based on a different and mostly lower risk profile. The obvious missing component of drawdown portfolios is an annuity product, reflecting the generally low and falling proportion of assets invested in annuities for clients in drawdown.

Drawdown is a broad term that advisers generally use to include clients who are not taking income after they have crystalised their pension, as well as those who are drawing an income directly from their fund. Some of those clients categorised as being in drawdown may regard their pension fund as IHT plans and are unlikely to draw on their pension for income. The portfolio they had in accumulation may well be generally suitable for their post-retirement fund – a different situation from those who need to draw pension income.

Figure 5: Proportion of clients whose risk profiles change when entering retirement



Source: Platforum, January 2020
For what proportion of your clients are risk profiles being changed in retirement compared with accumulation?
Base: 146 advisers

1.2.3 Capacity for loss

Capacity for loss is the other, often more important, component of the client's risk profile because it concerns the client's ability to sustain a reduction in value of their investments without it having a material impact on their standard of living. For most clients, capacity for loss should be measured by the impact of investment fluctuations on their long-term income and their ability to meet their expected spending needs. In many cases, it is likely that clients have a lower capacity for loss towards the end of their working lives and it will reduce further once they have stopped work, when the scope for them to mitigate their losses by working longer or saving more is severely limited.

The FCA has emphasised the importance of assessing capacity for loss for several years, although anecdotal evidence from our interviews suggests that some advisers do not really grasp the concept or assess it appropriately.

"It's a difficult one. I'm still not sure that all advisers get the capacity for loss bit."

One adviser whom we asked about capacity for loss illustrated their limited understanding of the concept when they said:

"IO scores it one to ten. Then obviously we have a conversation about it, you know: 'Are you a three? Are you a two? Are you a this? Are you a that?'"

Where capacity for loss assessments are carried out, they tend to focus on the impact of capital losses and generally do not model the effects on future income and different types of expenditure. Such assessments are arguably therefore not fully related to the realities of clients' real financial resilience and may underestimate the possible impact of losses. At retirement and then actually in retirement, the spending patterns often take on more importance in the financial planning process – with a greater imperative to distinguish between core expenditure and other types of less essential and more discretionary spending.

"Some advisers will dig into a risk analysis tool and look at probabilities of loss etc. They will discuss it in more detail with the client saying, 'You've come out as a 10%-20% potential loss client – are you happy with that? Or, because this is your life savings or your pension, would you like to take that down a notch or two?'"

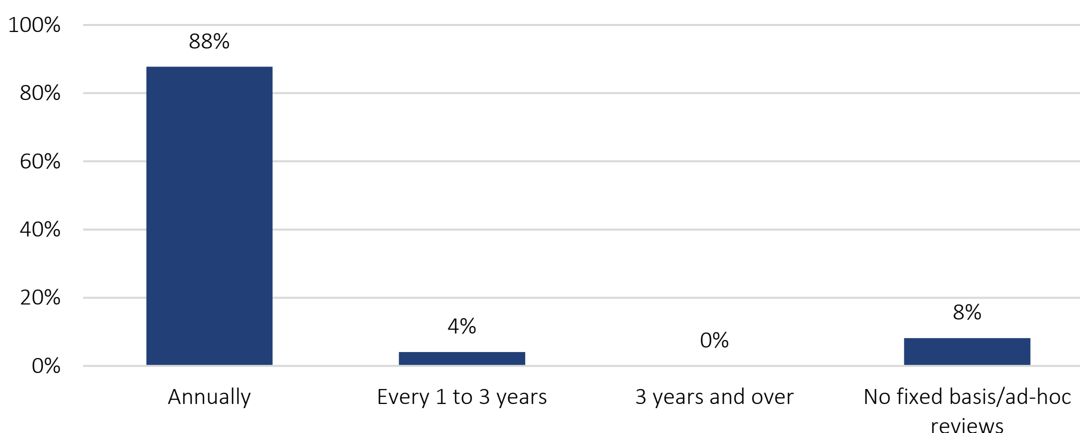
The main ways to assess a client's capacity for loss are:

- Questions in the risk profiling tool – although these are mostly very general.
- Informal discussion with the client based on the adviser's and client's understanding of the client's circumstances and needs.
- Modelling future income and expenditure outcomes using a long-term cashflow planning tool. Some advisers increasingly recognise this as the most robust way to assess capacity for loss.

"So, it's just taking people on a journey and this is where, as a professional adviser, some of our advisers in the business let people down, is understanding your client, thorough fact-finding, proper fact-finding, lots of open questions, just not paying lip service."

"I think the key thing is capacity for loss and what is really important is that you model the 'what if' scenarios. A couple who are retiring in their 60s may have huge capacity for loss, but that can change over time."

Figure 6: Frequency of reviewing clients' capacity for loss in retirement



Source: Platforum, January 2020
How often do you review clients' capacity for loss in drawdown?
Base: 147 advisers

We are starting to see some innovation in terms of formalising and quantifying capacity for loss. EV (formerly EValue) will shortly be launching a drawdown tool that uses stochastic modelling to estimate: the chance of running out of money, the likelihood of non-discretionary expenditure being met and the amount of excess capital. This excess capital over and above what the client is likely to need to cover their expenditure could be used as a proxy for capacity for loss – if the client has 130% of the estimated required capital for retirement, arguably they have a capacity for loss of around 30% of their portfolio.

Tools like this can also be used to model and compare different methods for providing income.

- How much does the asset allocation of a multi-asset portfolio impact on the longevity, robustness or income coverage of a portfolio?
- How does layering expenditure and purchasing income guarantees impact on the sustainability of portfolios?
- What is the optimum amount of secure income required to ensure a sufficient chance of success?
- Can secure income be used to underpin a portfolio, enabling the client to take a higher level of risk with the remaining assets?

We expect that quantifying capacity for loss and mapping it to portfolios/income sources will lead advisers to recommend greater use of secure income.

1.2.4 Attitude to pension drawdown income risk

There is a clear read-across from the FCA's approach to defined benefit (DB) pension transfer advice to the broadly parallel situation of advice on taking pension fund withdrawals, as set out in the Instructions for *Defined Benefit Advice Tool (DBAAT)* published in January 2021 and earlier in COBS 19.1.6G(4)(b).

The FCA's definition of 'attitude to transfer risk' is "the client's behavioural and emotional response to the risks and benefits of giving up 'guaranteed' benefits (or safeguarded benefits) for those which are flexible and not guaranteed." In this context, a lifetime annuity is similar to safeguarded benefits. On the plus side, the income from an annuity may provide more security than some private sector DB schemes; and on the minus side, annuities are generally not inflation protected. But the essential issues are the broadly the same.

The main issues are to do with the clients' wishes for:

- A lifetime income that is guaranteed regardless of how long they live, how their investments perform, how much they are able or prepared to pay for advice and whether they can cope with the decisions and uncertainties as they get older; compared with:
- The flexibility of access and the long-term potential IHT and estate planning benefits of pension drawdown.

There is some evidence to suggest that clients welcome the features of a guaranteed lifetime income, but they react adversely when they learn that the product in question is an annuity. As with DB transfers, clients can be insistent about the advice they expect to receive and – as with DB transfers – advisers have regulatory responsibilities that go beyond the demands of insistent clients.

Added to this is the suspicion that advisers may exercise their own conscious or unconscious bias – at least partly rooted in their own commercial interests – and do not always present annuities to clients in a wholly balanced way. Advisers seldom recommend the use of annuity products for a proportion of clients' portfolios.

1.2.5 Cashflow planning

Long-term cashflow planning is becoming much more widespread among advisers. Some 88% use cashflow modelling of some kind and 76% of these do it annually. But there is still a substantial minority who make little or no use of this approach to planning, and substantially more who undertake it using unrealistic assumptions (see Sections 1.2.5 and 1.2.6 below).

The original use of cashflow modelling was to project forward the clients' expenditure needs and then see if the forecast flows of income and/or capital will sustain them throughout their lifetimes. It is also a valuable tool for encouraging clients to envisage their future wants and needs and lifestyle.

"A lot more is now done on client aspirations. So we don't necessarily just say, 'You've got this amount, therefore I think you should do this.' We tend to ask: 'What do you see yourself doing in five years, ten years? Have you got any grandchildren you want to put money away for? Have you got any children who still aren't married, who might suddenly need money for a wedding or whatever.'"

"In reality, the spending pattern for most retirees probably takes two or three years to settle down. What they tell you they need when they first retire is often a bit of a guesstimate."

Advisers increasingly recognise that they need to return to the earlier cashflow models to see if they are still realistic and the client remains on track. Most revisit the process every year and regard it as one of the most important and valuable parts of the annual review process.

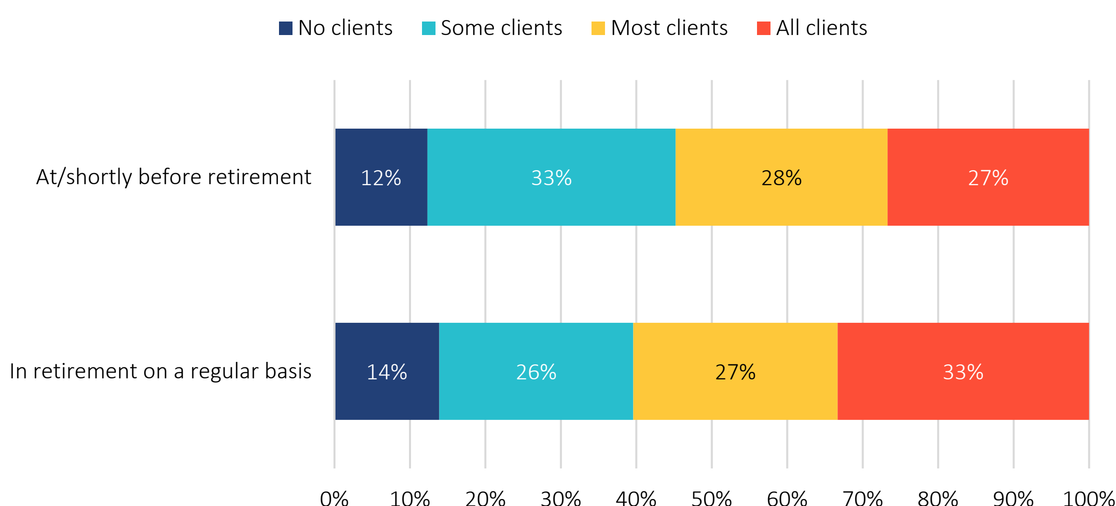
"Cashflow planning gives us an idea of sustainability. If somebody says, 'I want to draw down £x from my pension,' and you can clearly demonstrate that's not a good idea because there's every chance that money's going to run out then that's a good, powerful tool."

- The inputs to income data for cashflow modelling should include all sources of regular income, such as state pensions, DB pensions, pension annuities, income from properties and similar sources as well as earnings. The model should then make assumptions about future income or income and regular encashments of capital from investments.

- Estimating future expenditure accurately can be more problematic for advisers. Some clients are reluctant to analyse their current expenditure, although this should ultimately be easier once open banking is more widely adopted. Projecting future wants and needs can be difficult and may be an iterative process especially during the early years of transition to retirement. Determining core expenditure should be easier than forecasting expected discretionary spending or capital items.

"It's not something that's set in stone. What makes sense for a 60-year-old now might be completely different when they're 80."

Figure 7: Proportion of clients being offered cashflow planning



Source: Platforum, January 2020
For what proportion of your clients do you provide long-term cashflow planning?
Base: 146 advisers

Cashflow modelling can also be used for assessing capacity for loss, by analysing expenditure into different layers of priority and seeing how it might be affected by changes in income and withdrawals. Advisers can use cashflow modelling tools in a 'what if?' scenario to see how a substantial investment market downturn can impact on a client's income and expenditure going forward from the time of the major loss. Clients can easily grasp the possible impact on their core and discretionary expenditure.

"You have to have a conversation with a client and find out what is essential to that client. Something that I think is discretionary might be critically important to somebody else. The question is what do you need for a good life that you're going to enjoy?"

The use of long-term cashflow modelling is becoming more sophisticated and more useful in assessing capacity for loss with the increasing use of:

- Layering expenditure into core and various degrees of discretionary expenditure.
- Adjusting investment growth assumptions to match the recommended asset allocations rather than assuming uniform rates of growth such as 4% a year, which is increasingly recognised to be excessively optimistic. Many also take into account fund management, platform and other fees.
- Stochastic modelling to calculate the chances of portfolios meeting clients' goals helping them to understand the risks of different asset allocations and spending assumptions.

  "We use a stochastic modelling system. We were using a deterministic basis, but we've changed that in the last couple of years."

- Use of longevity assumptions that are based on the possibility that the client will live into extreme old age rather than the average life expectancy. Many advisers now use age 100 or 105.

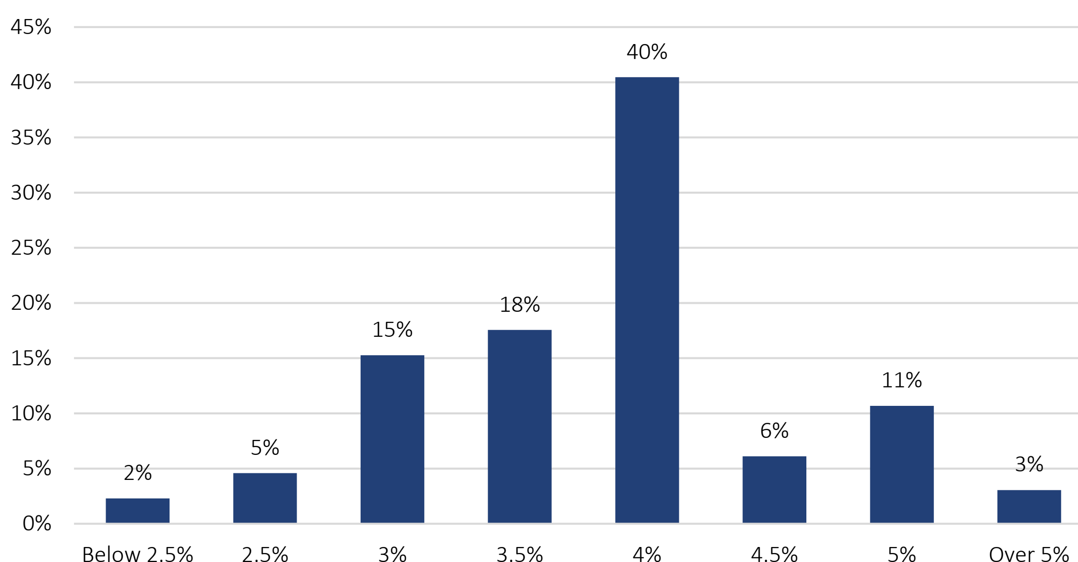
"We rely on cashflow planning for identifying capacity for loss. We would probably try and encourage advisers to split expenditure into three, rather than in two. There's the core expenditure, the lifestyle expenditure and then maybe the luxury expenditure. The challenge we have is that when you actually combine that with the risk profiling. We've not found too many clients in our world who actually are at risk of undershooting the guaranteed income from their core investments."

However, long-term cashflow modelling is varied in how it is practised in the adviser community and there is considerable room for greater standardisation to make it more valid and useful. Long-term cashflow modelling is increasingly becoming part of the risk profiling process in the planning stage. This is when the decision to buy an annuity is likely to arise most logically and naturally for both the adviser and the client.

1.2.6 Sustainable withdrawal rates

Nearly two-thirds (60%) of advisers say they regard 4% a year or more as a sustainable withdrawal rate and use it in their cashflow plans.

Figure 8: Sustainable rates of withdrawal used by advisers



Source: Platforum, January 2020
What do you use as a sustainable rate of withdrawal in cashflow plans?
Base: 131 advisers

A 4% or higher withdrawal rate from a portfolio may not turn out to be sustainable, especially if a portfolio is subject to early capital losses and annual charges of 2%. Such optimism about investment returns is unlikely to encourage advisers to recommend a secure lifetime income or any other annuity product to a 65-year-old client. But for some advisers, it turns out that they do not expect clients to maintain the concomitant expenditure levels.

"The idea that we'd tell someone that they'd need to take 4%, and it will increase every year with inflation, and will grow through retirement and, then, when they're 96, they'll still have the £60,000 a year in today's terms – that's crazy. They won't need that."

Using deterministic tools to derive a sustainable withdrawal rate only takes into account portfolio longevity. It takes no account of investment volatility and sequence risk, nor does it provide for a margin of error. A full assessment of the sustainable withdrawal rate requires stochastic modelling – the sustainability of income is a probabilistic assessment and therefore needs to be measured probabilistically.

We think that projected withdrawal rates should be based on realistic assumptions and stochastic modelling. One reason advisers are not recommending annuity-type products is that they overestimate the sustainable withdrawal levels that can be achieved from a portfolio and underestimate the degree of risk involved.

1.2.7 Longevity assumptions

Nearly half (48%) of all advisers use an expected longevity for clients of less than 95 years old. Nearly a third (31%) of advisers project to an age of 100 years or more. However, we think that too many advisers underestimate the risk of clients living too long.

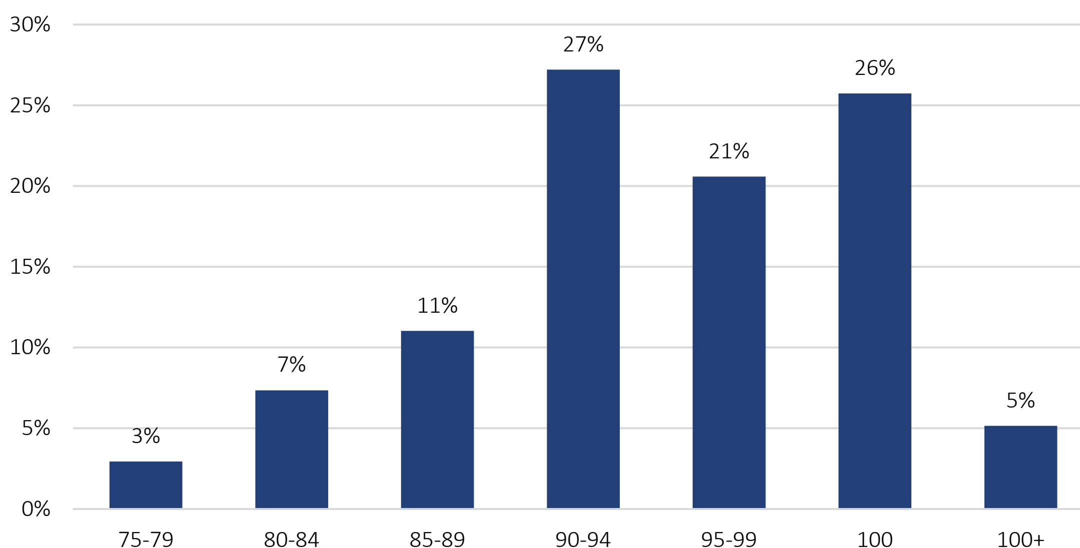
Advisers who do not plan for the possibility of clients living beyond age 90 or even 95 are less likely to take on board the merits of an annuity product that is essentially an insurance against living too long.

- A 65-year-old male has a life expectancy of 85, with a one-in-four chance of living to 92.[3]
- Advised clients are typically wealthier, and therefore much more likely to surpass the average.
- And finally, when serving a high number of retired clients, the odds are significant that some of them will live significantly longer than expected.

"We plan up to 100, which is just the way life is. If a client is over 80, we plan to 110. It would look a bit rude if someone is 90 years old and we said, 'start choosing your handles now.'"

Averages work well for a life company that is able to pool risk among thousands of policy holders. In drawdown, the longevity risk is individually taken on by the customer (and therefore indirectly the adviser). Advisers' under-estimation of longevity combined with use of deterministic modelling and cohort risk is leading to significant risks. It is highly likely that a crash at some point will impact on portfolios, leaving some clients with shortfalls who subsequently live longer than expected.

Figure 9: Longevity assumptions used in cashflow plans



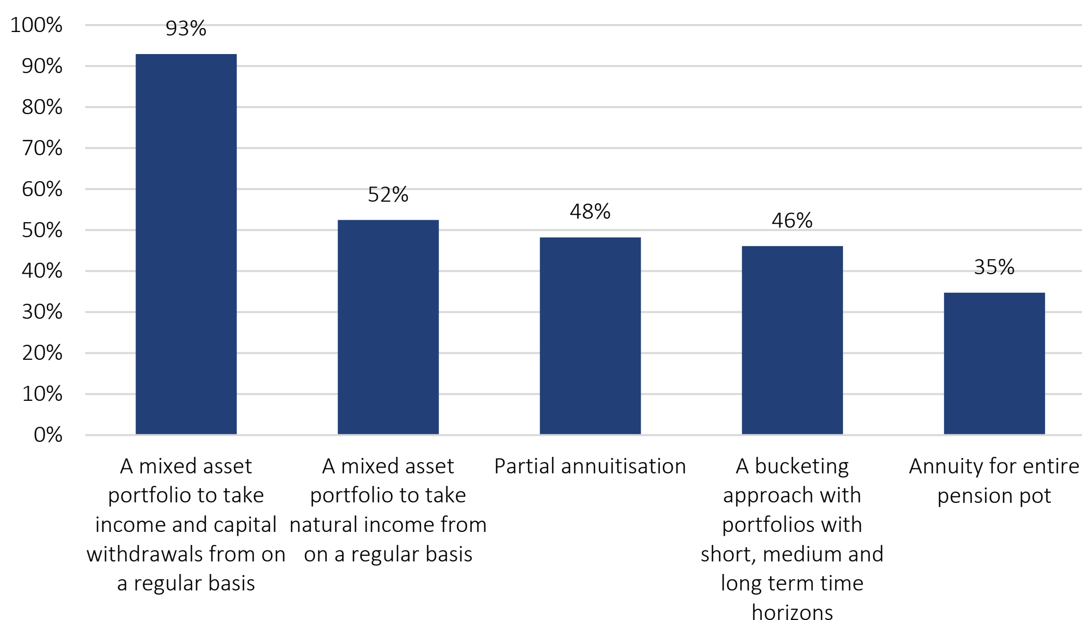
Source: Platforum, January 2020
To what age do you normally assume a client in reasonable health will live to, when creating a cashflow plan? Assume this is for an otherwise healthy male client aged 65
Base: 136 advisers

[3] ONS Life expectancy calculator.

1.3 Investments in drawdown

Drawing a combination of income and capital from a mixed asset portfolio is by far the most prevalent investment approach, used by almost all advisers for at least some of their clients (Figure 10). The portfolio chosen is mostly driven by an assessment of clients' attitude to risk. Some advisers will reduce clients' risk level post-retirement.

Figure 10: Approaches used for drawdown solutions



Source: Platforum, January 2020
Which of the following approaches do you use for setting up a drawdown solution for a client?
Base: 141 advisers

This chart seems to overstate the use of annuities by advisers. We know from industry statistics that annuities are a low proportion of at-retirement investments.

Just under half (48%) of the advisers in the sample said that they recommended *partial* annuitisation to at least *some* of their clients and just over a third (35%) reported that they recommended annuitisation for entire pension pots – but also only for *some* of their clients. In both cases, we think that in practice the use of partial or total annuitisation for some clients probably means very few clients indeed, especially in the last year or two.

Perhaps the more telling statistic is that over half of the advisers asked never recommend partial annuitisation and nearly two-thirds never recommend full annuitisation to *any* of their clients.

Bucketing – a method of risk management

Bucketing – having two or more risk buckets, one of which is likely to be cash for short-term expenditure needs – is becoming increasingly popular despite the very low returns on deposits.

"I will have three time periods: One is the now, if they're taking income. Sometimes they're not, they might just be taking tax free cash. There's the three to five years, where that pot is going to top up the immediate income pot and there's the other pot, which is basically a bit of growth. Those pots have different attitudes to risk."

Bucketing is mostly being used as an extension of a mixed investment approach, with two or three risk-targeted sub-portfolios. The low risk bucket is often kept in instant access cash accounts and acts as a drag on the whole portfolio. While it is described as insurance against potential market falls, it is typically used for income and topped up at clients' annual reviews.

Annuity Purchase

The proportion of advisers recommending annuity purchase either as part of a solution (48%) or as the total solution for a client (35%) is now a minority – although still a substantial one. But the number of clients involved is likely to be very low in many adviser firms. The overall level of annuity business has continued to decline – down a further 6% to fewer than 70,000 annuity purchases in 2019/20[4] – although that represents a much wider population than just the adviser market.

There is some evidence of a revival of interest in annuity purchases and particularly blended solutions.

"We've seen a lot more annuity work recently than I've seen in the first eight years of paraplanner. I've seen more annuities in the last two years than I've seen in the last ten."

"Some advisers are focused on meeting the essentials with secured income and then playing with the rest. Before, everything went to drawdown and no-one really thought about it. There's much more of a hybrid approach now."

1.3.1 Dangers from the current approach to advice

There is a great danger that advisers will present their clients with an overoptimistic assessment of their chances of running out of money towards the end of their lives.

- Clients' actual asset allocations may generate much lower returns than those projected by advisers, especially if they are based on rules of thumb about 'sustainable returns' that are based on higher exposures to equities.
- Deterministic modelling – unlike stochastic forecasting – tends to produce binary conclusions: either the client will or won't run out of money by the end of their lives. Answers should be based on probabilities, which in most cases will not be the 100% certainty conveyed by the deterministic model.
- Longevity assumptions using age 95 as the end point could leave as many as a fifth of 65-year-olds in deficit at the end of their lives.

[4] *FCA Retirement Income Market Data 2019/20*, 29 September 2020

2 A BETTER APPROACH TO RETIREMENT ADVICE

We think that SLI would meet the needs of many clients at- or in- retirement but that some major changes are needed in the market, and especially in many of advisers' processes for the full potential of the product to be realised.

After talking to advisers, we think that the demand for the SLI product will come from advisers with clients who are largely or wholly dependent on their DC pension pots to provide their incomes in retirement. Some of these may turn out to be clients who draw on their other income and assets in the early years of retirement, but then need to draw on their pension funds later.

We also think that the SLI will appeal to people who want and need an income that will last their lifetimes and will provide for their core expenditure. This of course will require identifying core expenditure as well as understanding clients' views of the desirability of having a lifetime income balanced against the flexibility of access to capital.

This chapter sets out how advisers' understanding, attitudes and practices may need to change in order for the SLI to be more widely accepted and purchased.

"We've got to a situation where annuity is a dirty word. When pension freedoms opened up, they allowed people to reject annuities because they no longer had to buy them. I think we need to have a middle ground where we look at annuitising that bottom layer of non-discretionary income and then perhaps, have flexible income for the other capital on top of that."

2.1 A clearer understanding of the benefits offered by securing income

The pensions changes of 2015 were essentially characterised as freedom from the need to buy an annuity and as such was widely welcomed by many investors. Before the changes, they seldom needed to consider their merits because most clients were forced to buy an annuity if they wanted an income from their pensions. Following these changes, advisers have mostly focused on the advantages and challenges of drawdown.

It is now time for advisers to remind themselves about the essential characteristics and features of annuities and how best to articulate these to clients. There is a widespread view that annuities are poor value, which should be countered by explaining why this is not the case, in particular:

- The reduction in annuity yields are caused by the same factors that have made drawdown so much more challenging and risky: the decline in interest rates – with its impact on other nominal returns – and the increase in longevity that has meant that retirement funds need to last longer.
- The beneficial effects of pooling risks that mean annuities provide insurance against living too long and the increasing importance of this feature as ever larger numbers of clients live into their late 90s or even longer and are in increasing danger of running out of money during their lifetimes.
- Annuities currently provide more effective diversification than bond funds. The returns are uncorrelated with equity performance and could therefore allow a higher proportion of an investor's remaining portfolio to be invested in equities to generate longer-term overall returns.
- The returns from annuities are likely to be higher than from low-risk bond funds because they are underpinned by corporate bond yields and lifetime mortgage returns.
- The returns from annuities are further boosted by the mortality risk premium generated by policyholders who die prematurely.
- The returns are also more secure than bond funds because they are guaranteed under the FSCS.

Against these benefits, the client has to consider the potential drawbacks of inflexibility, although these are mitigated to some extent by the features of the SLI. There is a trade-off between the guarantees of annuities and the flexibility of drawdown that advisers need to understand and explain.

2.2 The perception of annuities as being poor value

Back in the year 2000 annuities for 65-year-olds generated roughly 50% more income per thousand pounds as they do now. In the early 90s, the yields were double what they are today. It is understandable that many advisers and their clients currently regard annuities as relatively poor value for money – compared with the past, especially if they have long memories. But lower returns are not the same as poor value. They are simply the result of greater longevity and much lower interest rates.

- The past is not a good guide to value in this context. It is much more helpful to look at alternative ways to secure the equivalent level of more or less guaranteed lifetime income from a capital sum.
- The fact is that if an investor used low risk bonds to generate such an income, they would need to invest a lot more to achieve it. What's more the interest returns are less than an insurance company can achieve on such lines of business as lifetime mortgages and similar investments.
- With drawdown, the individual investor is on their own and doesn't get any of the advantages of pooling to spread the risk and reduce the cost in the way that an annuity does.

Annuities provide cover for longevity and investment risk, to a level of certainty that individual investment portfolios simply cannot achieve. A very large investment portfolio is required to come close to certainty, demonstrating that annuities in fact represent excellent value for money, contrary to much adviser and client opinion.

For example, an SLI for a 65-year-old in good health generating a guaranteed lifetime income of £5,000 a year would use £104,672 of a drawdown fund. There would be zero risk of the £5,000 a year income running out before they died or its ceasing because of investment losses. The life company guarantee of lifetime income is covered by the FSCS.

In contrast, a moderate risk portfolio of equities and bonds would require 51% more capital allocated (£159,000) to generate an equivalent lifetime income – and crucially it would be with a 90% chance of achieving this goal. In other words, the longevity and investment risks would mean that there would still be a 10% chance of the client running out of income before they die. A low-risk investment portfolio would require even more capital (over £175,000) to meet the same goal.[5]

If certainty is required for at least some portion of income, such as core expenditure, an annuity can offer surprisingly good value for money.

2.3 Recognising the trade-off of guarantees and flexibility

Discussions about income should broadly mirror those that advisers are required to have with clients when considering the relative merits of transferring from a DB pension to a DC pension pot. Advisers should lead discussions with clients about the trade-offs of guaranteed income for life as against flexibility of access/liquidity.

Most clients like both certainty and flexibility. A crucial part of the adviser's role should be to work with the client to create the right balance. SLI would typically be used as part of a blended solution providing a mix of guaranteed income to cover core expenditure and drawdown to cover more discretionary spending.

"[The SLI product] does give that flexibility. From a psychological point of view one of the key barriers to annuitisation is the idea that you're having to give away a large lump sum. You're almost having a bet with the insurance companies as to whether you will win out of it or they will... We see this as having a role to play as part of a mixed solution, a hybrid solution to retirement planning."

Lack of flexibility is the standard criticism of conventional annuities voiced by most advisers and their clients. Not only does this place clients' finances on rigid tramlines, but it can limit the scope for advisers to make recommendations. With SLI, the flexibility for withdrawing guaranteed income from the pension fund or accumulating it tax free within the fund opens up scope to diversify, tax-plan and adjust the income required to meet varying expenditure in different years.

[5] Source: Just stochastic projections, SLI rates and investment assumptions correct as at 15 October 2020.

Some advisers recognised the flexibility offered by the SLI contract being written within the client's SIPP, allowing them to accumulate payments tax-free within the fund or pay all or some of it out to the policyholder if they need the income. Advisers saw the opportunities that this could provide for tax-planning, which many of them regard as a valued component of their services. Some also recognised that the scope to accumulate rather than pay out income could allow them to recommend purchasing secure income earlier than they might otherwise have considered.

2.4 The role of risk profiling in establishing need

One of the key processes that advisers undertake with clients is to establish their risk profiles – their psychological tolerance of risk and their capacity for sustaining investment losses without it materially affecting their lifestyle.

Risk profiling has been largely developed for the relatively simple process of capital accumulation, generally producing a single score for a whole portfolio. There is a case for rethinking the process to make it more suitable for decumulation:

- Risk profiling generally revolves around the client's tolerance and capacity to cope with losses of capital. But in retirement, most people are much more concerned with the impact of fluctuations of investment values on their incomes. Risk profiling for clients in retirement should be more closely focused on income issues and therefore on assessing capacity for loss. Where clients are drawing income from their pensions, it is unlikely that the portfolio they had during most of their accumulation stage of life will continue to be suitable for generating income.
- Income needs are defined by spending levels. Some expenditure has a very high priority for clients – the core unavoidable outgoings on housing, food and other essentials. If clients don't have enough income to cover this type of spending, they will find themselves in considerable difficulties. Other spending is likely to be more discretionary to a greater or lesser degree and clients might well find it easier to cope with fluctuations.

  "You need to ensure that people's basic income is guaranteed and covered."

- In principle the core expenditure is a strong candidate for being covered by the clients guaranteed income state and DB pensions. If that is insufficient, it could be topped up with an SLI or other annuity product. Many advisers do not analyse the different priorities for income – we think they should.
- In advisers' risk profiling processes, capacity for loss often receives less than its due weight. What's more, the integration of capacity for loss findings into the risk profile score is generally haphazard. There should be a clearer methodology for integrating the two different findings to create a score. Arguably any negative capacity for loss considerations should normally outweigh clients' more optimistic attitudes. We think that the excess capital model pioneered by EV (formerly EValue) may well provide the most robust starting point for future assessments of capacity for loss.
- Risk profiling typically generates a single score, which is generally suitable for accumulation of capital. The prioritisation of expenditure into different layers should mean that there might need to be different risk scores for different bands of income – and possibly different recommendations. Some advisers are using bucketing to achieve a similar result (Section 1.3) but bucketing typically involves allocating *assets* into different levels of risk, rather than allocating *income*.

2.5 Better use of cashflow modelling

Cashflow modelling is the single best way to help identify clients' needs and the risks to their future lifestyle. The need is to promote, adapt and refine the advisers' approach to cashflow modelling, working with advisers, tool developers, and professional bodies:

Promoting the widespread and universal use of sound cashflow modelling could assist advisers with retirement planning. We think that there should be clear and widely-used standards for cash flow modelling. The professional bodies could develop these in conjunction with the tool-makers and the advice profession.

- Advisers use a wide range of assumptions for cashflow planning, some of which are flawed, e.g. on longevity, where the risk of living too long can be underestimated. It would help to spread best practice about assumptions for client longevity, investment returns, inflation etc.
- One of the greatest barriers to effective use of cashflow modelling is the collection of expenditure data which both clients and advisers often regard as tedious and time-consuming. However, it is useful for retirement planning and essential for longer term monitoring of income and spending. Open banking and the collection and collation of spending data should make this easier and should be promoted.
- Advisers should analyse layers of expenditure and the advisory profession should develop standard or at least more widely accepted approaches to cashflow modelling and categorising expenditure.
- Advisers do not use stochastic modelling in cashflow analysis as widely as they should. This approach has been available in almost all leading cashflow modelling tools for some time and would help advisers and their clients to understand the likely outcomes of different recommendations such as adding SLI to the investment mix to reduce the risk of running out of money. Clients and advisers should understand that many clients face a future in which there is a possibility of expenditure eventually exceeding income, which is not reflected in deterministic projections. In many cases, the inclusion of SLI in the mix will reduce the danger of this possible outcome.

There are still many advisers who reject the use of cashflow modelling because they do not properly understand its potential to stimulate clients to think about their futures and to provide meaningful ways to provide more suitable advice. There is a need for further adviser education by tool providers as well as adviser firms themselves.

"Cashflow is there but it's rather sterile. It's just a numbers thing. What's important is how the client is living their life."

2.6 The role of the regulator

The regulator has issued signals that it has anxieties about the quality of advice being given around retirement, and has announced that it would review the pensions and investment advice market for a second time, with a focus on the advice that consumers receive around retirement income. Unfortunately, this review was pushed out to 2021 with the process possibly continuing into the second quarter.

We think that the issues raised in this white paper are central to the review and that it should receive the highest priority. Client detriment is mostly likely to occur in the longer term. in the final years of clients' lives, after most of the current generation of advisers and product provider managers have themselves retired. Preventing this long-term client detriment will depend on early action; 20 years' time will be too late.

In the meantime, on prudent compliance grounds alone, we believe that advisers should take seriously the FCA's proposed emphasis on income in retirement. They should:

- Make sure that they review their risk profiling processes to ensure they are appropriate for income issues and in particular put more emphasis on assessing capacity for loss and the use of cash flow modelling for this purpose.
- Review their cashflow modelling practices, analyse clients' ongoing spending priorities and use them to model clients' capacity for income loss. The regulator should also consider encouraging the much wider use of stochastic methods to assess the probability of clients' spending exceeding their income in the longer term.
- Read across from the FCA approach to DB transfer advice and consider how they present annuities and especially SLI to clients so that they understand the trade-offs between flexibility and certainty, the risks of not annuitising and the diversification benefits of annuities.

2.7 Selecting the level of guaranteed retirement income required

Annuities are no longer an all-or-nothing choice. They can be used as one element of a diversified portfolio. They could be used to cover all non-discretionary income or just act as a partial hedge against longevity risk. Advisers would need to determine how to trade-off the risks of different approaches for each client.

It has been suggested that annuities could be considered as a separate new asset class and that portfolio design might be restructured to some extent for annuities to replace bond funds as assets that are not correlated with equities in order to achieve investment diversification.

Advisers don't naturally regard annuities as an asset class and seem resistant to the idea. They see SLI and annuity products generally as a secure source of income. However, they do understand how the purchase of SLI could affect the asset allocation for a client's portfolio. It would allow a client to take on the greater risk of holding a higher weighting of equities in their portfolio as a result of their having the ballast of the secure lifetime income.

The decision whether to recommend SLI or other annuity to a client is firmly in the hands of advisers. It seems unlikely that DFMs will take on this role unless they are also advisers. Advisers assert they are in much the best position to carry out the factfinding dialogue with clients about their longevity, income needs and health on which annuity purchase depends.

"We first identify whether the client needs this solution and then we can find a way of adapting it, but what we do is bespoke, isn't it? We're not commodity sellers."

2.8 Threats to adviser businesses from decumulation advice

Advisers are rightly anxious about the possibility of decumulation going wrong. The risks are predominantly:

- Regulatory – the rise in PI cover for DB transfers demonstrates that insurers are nervous that current suitability assessments will be deemed to be poor.
- Legal – with a significant potential of dissatisfied clients and their descendants.
- Reputational – for the industry as well as individual firms.
- Business valuations – any potential for regulatory action or future claims by clients has the potential to derail the future sale of an advice business. Business owners planning to sell their business on retirement might find their own retirement dreams dashed.

These should be strong motivators towards the provision of good advice in decumulation.

"I think it was [Nobel Prize-winning] William Sharpe who said that decumulation planning in retirement is the hardest problem in finance, because you have uncertainty around longevity, inflation, spending needs and investment returns. And that's a lot of uncertainty."

We asked whether the potential loss of income to adviser firms as a result of switching funds from drawdown to annuity products would affect advisers' advice to clients. We think that potential regulatory and similar issues with 'doing the wrong thing' or the more hazardous thing would lead most advisers to recommend more annuity purchases if they thought this approach was appropriate.

We asked advisers for their assessments of the biggest risks facing their retired clients and the biggest risk to their firms. Unsurprisingly, the two sets of risks were closely related and relevant to the content of this report.

- They thought that by far the greatest risks to clients were the likelihood of their taking excessive withdrawals and spending too much.
- The top two risks facing their firms were unrealistic cashflow planning and unrealistic risk profiling.

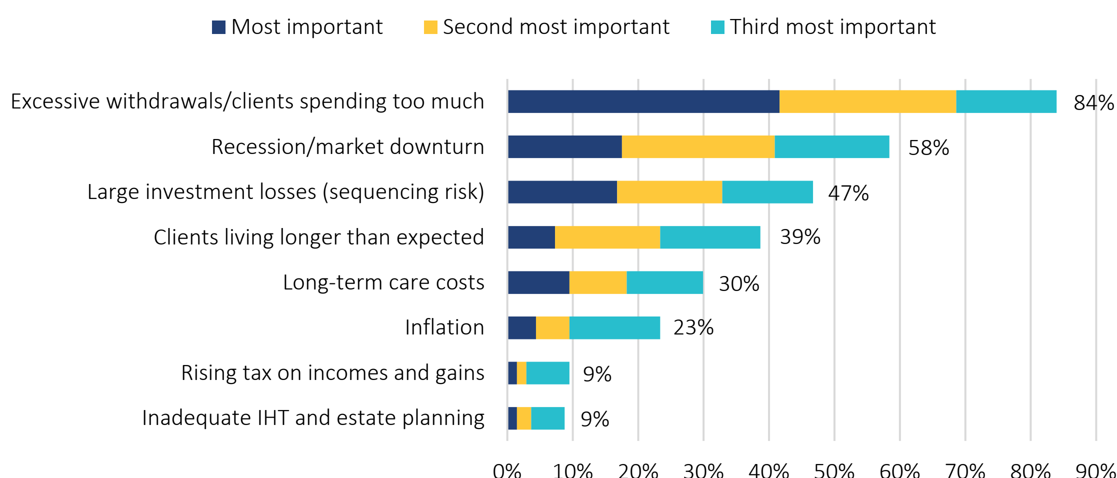
It is clear that advisers are looking for products that will help their clients meet their spending needs and that they are anxious about the rigour and validity of many of their own planning processes.

"I can't imagine that any annuity-driven product now is going to give a fantastic yield because it can't. But is it a good alternative? Yes, it sounds like it, on the face of it."

"I think anyone who puts their assets under advice figures ahead of client needs is heading for a rude awakening at some point, particularly with the regulator. We've always believed our clients trust us to look after them. If you do that consistently over many years, then, commercially, that's the best policy as well."

It is an interesting to contrast the relatively very low level of annuity purchase recommended by advisers with the top four risks that they have identified for their clients' long-term financial futures. Each of the risks would be significantly mitigated by the use of the SLI or other annuity purchase.

Figure 11: Biggest risks facing advised clients' financial plans in drawdown



Source: Platforum, January 2020
What are the biggest risks to your clients' long-term financial plans in retirement?
Base: 137 advisers

Possible regulatory action

There must be some doubt as to whether advisers are generally likely to consider the use of annuities without some regulatory persuasion to do so. The emotional response to 'pension freedoms' is implicit in the expression itself. The behavioural bias by clients against annuities, together with an understandable commercial impulse to build funds under advice, has led to a rapid and arguably unwarranted decline in the sales of annuity products. We think that many advisers will not evaluate the need for at least partial annuitisation with sufficient care and objectivity unless the regulator makes its views on the issue clearer.

An indication of the way the regulator deals with the parallel issue of pension transfers from defined benefit schemes is in COBS 9.22R (2), which requires advisers to ascertain clients' attitude to transfer risk. This has been further explained in the FCA's recent *Defined Benefit Advice Assessment Tool (DBAAT)*. Guidance and clarity would help advisers reconsider this issue – a formal rule change is probably not necessary.

Advisers should probe a client's behavioural and emotional response to giving up guaranteed benefits for those that are flexible and not guaranteed.

- They should ask clients fair clear and not misleading questions about their attitudes to guaranteed versus flexible income.
- They should employ a good balance of questions that can result in a spread of responses from different clients.
- The language should be unbiased and should not steer clients towards answering in a certain way.

These words have been recontextualised from the FCA's publication and are very appropriate for deciding whether to incorporate an annuity into a client's drawdown solution.

DB pension transfer decisions are not the same as deciding whether to buy an annuity as part of a drawdown solution. But there are common factors that make them parallel processes. Advisers should understand the parallels and similarities and apply similar processes in line with the FCA's apparent direction of thinking in the DBAAT. At the same time, it would help if the regulator made its views about annuity purchase clearer.

3 ADVISERS' VIEWS OF THE SECURE LIFETIME INCOME

3.1 Overview of adviser reactions to SLI

Many advisers told us that they reacted positively to the SLI product for its specific characteristics and features as well as the scope for annuities generally for some retirees. Advisers see a place for an evolved annuity product, albeit with a small but potentially expanding audience.

- The ability to cash in some of the pot within the first 6-8 years of the term is a positive feature for retirees who are getting to grips with their new circumstances.
- The flexibility from holding the SLI within a SIPP is valued by advisers who understand the benefits.
- Advisers recognise the potential for some clients to combine the use of the SLI with drawdown solutions, where the annuity provides a solid base for core essentials and drawdown provides the flexibility for more discretionary spending.

3.2 Adviser attitudes to annuities

SLI is essentially a lifetime annuity product with some additional attractive features. The main determinant of adviser attitudes to SLI is therefore their view of annuities more generally. Some advisers are enthusiastic about annuity purchase:

"We're very keen on annuities – yes, very keen. We place about 550 a year usually."

But many are less enthused:

"We don't do many annuities, but it's part of our advice process and is checked from a compliance point of view."

Advisers mostly view annuities as retirement income solutions for very low risk clients and for those with very small pension pots. Relatively few regard them as products to use routinely for providing core income to cover non-discretionary expenditure as part of a blended solution.

"We've done it for a couple of people where we've taken 50% of their pension and used that to buy an annuity to secure a basic income – on which they can survive, but not really live – and then switch to drawdown for the rest."

- Many advisers consider annuities are now generally poor value in view of increased longevity and especially because of ultra-low interest rates.

  "They're a great solution, depending on what client needs are. We'd probably prefer to do them much more often for base income needs. But the rates are just diabolical."

- They also believe that most clients dislike annuities. Partly this may be due to a perception of low returns.

  "I used to work a lot with annuities, but I think the man in the street, the average client, however you want to phrase it, now looks at it and thinks, 'It's not the best return I've ever seen.' That's the trouble."

- But many advisers think that annuities have a poor reputation with many clients and that the problem is really more of a public relations challenge.

  "I think the hardest thing they'll have to accept is the name 'annuity'. We're going to have to give it another name, we're going to have to rebrand it."

  "The other aspect is that drawdown is quite popular – people like the idea of flexibility, but are also a little bit resistant to annuities. We call them a 'secure lifetime income' or 'guaranteed lifetime income'. I think the poor old annuity has got a bit of a brand image problem."

- Some see more scope for annuity purchase for clients in poor health where it would be possible to take advantage of better rates.

  "We get enhanced terms for over 65% of the people we advise on annuities by asking the right questions."

3.3 Features – SLI on-platform

Advisers we spoke to generally understood and liked the flexibility provided by holding the SLI as a trustee investment plan in a SIPP rather than the life company paying it directly to the client. Most regarded the ability to hold income on the platform as providing scope for useful short-term income tax planning.

"If you partially annuitise in this way, you could have a variable income, and that is quite important to clients. Most people in retirement don't want a fixed amount of money. Occasionally, they might want to go on holiday or buy a car."

Some could see the possibility of building up accumulated income over several years to emulate certain of the characteristics of a deferred annuity.

"I've always felt that the ideal product for drawdown is actually a deferred annuity, which protects people against living too long."

"I like the idea that you've got that flexibility, so that if you find you're accumulating more income than you actually need to spend, you can retain it within the trustee investment plan, which means you've got tax-free growth and income. It's there to accumulate for later years' income when you may then need the income if you need care. Alternatively, if you're lucky enough to avoid that, you could build up a lump sum to leave to a dependent or the next generation."

Advisers also liked the convenience of the platform administering the PAYE on pension income payments.

"Taxation will be dealt with by the platform in the normal sort of way as with a drawdown. That adds some simplification regarding their tax."

3.4 Features – early death and surrender values

Guaranteed death benefits

Advisers understand the need for guaranteed death benefits in the early years of annuity payments and generally take them for granted as a standard feature in practice of almost all annuities.

"There's definitely something to be said for having certainty of death benefits."

SLI's surrender value in the initial years

But when we asked about the SLI's surrender value in the initial years, some found it helpful for the flexibility it offered clients, although most thought it was more valuable for psychological reasons and probably would be rarely used in practice.

"What you don't want to do is find that you've taken an annuity and then you're stuck, you can't cash it in. An ability to cash it in does sound like potentially a helpful feature."

"[The surrender value in the early years] is just there to give that psychological comfort that if they change their minds, they've got a get-out clause. I can't see it being used in many cases –that would imply that the initial advice wasn't correct, unless something drastically changes in the client's circumstances."

But other advisers felt that the surrender value feature had relatively little value.

"I think that if somebody's going to buy an annuity to give them a secure income that allows some degree of flexibility, enabling them to cash the whole thing in in the early years is probably not a particularly good idea. So that's not a feature that I am in favour of."

There were mixed views about using the early years surrender value as a basis for charging clients on a percentage of assets under advice. Some were comfortable with the suggestion, while others were less so.

"I would be reasonably OK with charging a fee based on the asset value – the surrender value."

"If you can justify the fee for the services you're providing the client, then it's fine. But just because there's a value there, I would question the justification for charging a fee on that basis."

3.5 Other adviser reactions to the SLI product

Value of SLI as diversification from equities

We asked advisers whether they would consider an annuity as an asset within a portfolio and a special asset class of its own for purposes of diversification.

Advisers are prepared to see the SLI as a way of diversifying clients' *income*, but few seem prepared to accept that SLI or annuities more generally could be considered as an investment asset class as such. They regarded the SLI as an annuity and therefore a source of income, but they regard an asset class as a categorisation of funds that can be bought, sold and valued as a capital item on a long-term basis.

"It's quite simple in the sense that you get paid that regular income and it's not subject to market risk. So, I don't see that as being a difficult one."

"I don't think it is an asset class. It should be deemed as a one-off life decision. It's a one-off purchase and once it has gone, it has gone."

Single life level SLI

Advisers generally said that they would like to have the option of establishing a joint life SLI where they thought that would be appropriate. There was even the suggestion that there might be a place for long-term guarantees (e.g. 20 or 30 years where one spouse was in relatively poor health). They thought the feelings of security provided by the joint life arrangement would appeal to the type of client who would want an annuity.

There seemed to be little demand for escalating SLI plans because of the time they would take to break even compared with plans that generate a level income. The possibility of topping up the annuity as and when needed seemed to provide the flexibility required. Several advisers commented that clients' expenditure often dipped after they had reached the end of their active retirement periods – typically some time in their 80s.

"It is really important that we ensure that there's enough income at the start of the retirement. Also, if the main pension owner were to die, the widow [or widower] would be adequately supported."

Pensions as IHT plans

The default advice of virtually all advisers is to regard pensions as the last assets to draw on, because they can be passed down successive generations free of IHT. Many clients have such high levels of assets that they do not expect to draw on their pensions at all and would therefore intend to retain as IHT-free funds.

Even clients who might well expect to draw on their pensions would want to postpone an annuity purchase until the time when they start drawing on it.

"We'll use a proportion of their funds to secure the income and then treat the balance as a potential IHT vehicle."

"Most people don't have everything tied up in a pension... You can get a lot of the income that you need from other sources than the pension."

Link to a single platform

The current availability of the SLI on just one platform is a limiting factor for many advisers. Some were not keen to extend the range of the platforms they use just to use the SLI. Others raised questions about the future transferability of the annuity to other platforms if the need arose.

"I'd really like to see it on other platforms. Novia might be fine but we need to see it on other platforms as well."

Openness to new products

In general, there is an openness among advisers to new product ideas because they recognise the need for a range of options for clients in retirement.

"Just tends to offer pretty reasonable rates. So, that may put them at the forefront in terms of what's on offer. I think whenever you're having a retirement meeting with a client it gives you another option to tailor into their needs. So, it just opens another door, gives you another avenue to pursue."

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