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The future of retirement
Opportunities for product innovation in the retirement income market

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Contents

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This report is aimed at manufacturers, distributors, and others with an interest in the retirement products market, who are looking to understand the landscape for innovation within the pensions sector and the specific product development opportunities this may open up.

Foreword – COVID-19 and the retirement market

COVID-19 has had – and is still having – a profound effect on work, markets, and the economy in the UK and across the globe. It is expected that these effects will extend well into the future. COVID-19 has brought a degree of economic turbulence and uncertainty unseen since the introduction of pension freedoms in 2015, creating pressing challenges for those building up and making decisions about their retirement savings.

This report explores barriers to innovation in the retirement market following the introduction of pension freedoms and considers where innovation may occur in the sector in the future. The need for innovation to meet consumers' changing needs existed before the COVID-19 pandemic, and the barriers for innovation and opportunities discussed in this report are, on the whole, not specific to COVID-19. However, COVID-19 has significantly accentuated certain existing trends and consumer responses and behaviours. This has undoubtedly made the already formidable challenges facing many consumers greater still, creating a correspondingly greater need for product innovation.

These trends, behaviours and challenges include:

- **Changing perceptions about longevity expectations.** Most people underestimate their longevity significantly.[1] The COVID-19 experience may exacerbate this perception, especially for people who are close to or at retirement, or with certain health risk indicators. This may increase the risk of their making sub-optimal choices with regards to their pension – such as withdrawing larger amounts for short-term consumption. Loss aversion coupled with longevity underestimation may further reduce appetite for guaranteed lifetime income products.

- **A low-for-long interest rate scenario.** The monetary policy response to the pandemic has taken nominal interest rates to unprecedentedly low levels. Even before this latest monetary intervention, the low-interest rate environment was one of the main barriers to innovation in the retirement market. And while some voices are warning of looming inflation risk, most firms that may previously have been hoping for interest rate normalisation are now likely to be expecting a longer period of very low – or even negative – interest rates. This is likely to reduce further the existing faint appetite for what were already low guaranteed rates and make it still more challenging for firms to create innovative products with a secure income base.

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As these factors all interact, no one factor presents the opportunity for a 'silver bullet' solution to create a more innovative product environment.

- **Financial decisions in times of stress.** People may make quick and sub-optimal decisions with regards to their pension pot(s) when they face heightened uncertainty or are in financial distress. This may include withdrawing parts of their pension to support themselves or family members in the short-term, without understanding the long-term impact of that choice on their retirement income (or through necessity), or at a large, but misunderstood and unanticipated, tax cost. People may also make decisions about their investment portfolio that seek to reduce risk, such as moving from equities to more cash-type instruments like short-term treasury bonds, but which actually carry a significant risk of reducing future retirement funds when inflation is considered. For non-experts, market volatility can be especially stressful and lead to uninformed de-risking. Whilst a de-risking strategy may be appropriate for people approaching retirement, uninformed or rash decisions may reduce future returns and therefore income, sometimes significantly. Consumers holding high levels of cash outside of the immediate term to retirement has been a concern of the FCA even before COVID-19.
- **Pension pot sizes.** While the immediate effect of market volatility during the COVID-19 pandemic will affect those closest to retirement the most, the larger effect of economic conditions – principally reduced employer contributions, risks of unemployment and potentially a long term reduction in investment returns and dividends – will be felt by those in early to mid-career. A small change in pension contributions and investment returns will have a larger compound effect on retirement income in the future, with the effect being more pronounced, all other things being equal, the further the saver is from retirement.

Given the above, our view is that the COVID-19 pandemic has increased the risks to consumers of poor and sub-optimal decision-making, especially for those who do not take or cannot reasonably afford professional advice. It is, therefore, ever more important that firms find ways to engage with consumers in ways that enable good decision-making. Product innovation, as we discuss further in the remainder of this report, will be key to continuing to serve a market that has increasing choice, but also faces increased complexity and uncertainty, as to how to deploy its retirement savings.

Executive summary

The introduction of pension freedoms in 2015, coupled with the growth in defined contribution ('DC') pensions have, on the face of it, created a compelling market need for product innovation in the UK retirement sector – a need that has only been heightened by the COVID-19 pandemic. Certainly, policy makers[2], and some market players, expected innovation following pension freedoms.

However, to date, there has been limited mass market innovation in the retirement products available to consumers[3]. The primary focus of firms has instead been to increase consumer engagement and support decision making.

In this report, we set out to consider why this is the case, with a focus primarily on the mass market. Specifically, we look at the challenges faced by organisations wishing to create more innovative retirement income products and how these may be mitigated. We also consider where, as and when these challenges are overcome, innovation may occur to create new products to meet consumer and market needs.

To help inform this report we conducted interviews with insurance companies, wealth managers, industry bodies and regulators. We are grateful for the contributions of all those who took time to share their views.

Consumer needs

Following pension freedoms, consumers looking to access their pensions have more options as to how they do so. The flip side of this extended choice is that the decision is, in many ways, more complex for most consumers. Due to the size of many pension pots and also as a result of the widely recognised advice gap, many consumers take these decisions without advice[4].

Fewer consumers are now purchasing annuities, and so many are now faced with managing their own investment and longevity risk. Low pot sizes also create a need for further investment growth in retirement. These are complex areas and consumer understanding of longevity is low, with most underestimating their longevity significantly. Prolonged low interest rates have also reduced the popularity of annuities with consumers due to the impact on annuity rates.

Taking this alongside the continuing shift away from defined benefit ('DB') pensions, it is clear that consumers will need to think differently about how they will fund and manage their retirement income. The risks of making the wrong choice are high and the FCA is alive to this fact in both the non-advised and advised space[5].

Barriers to innovation

In our view, a combination of factors has acted as a significant brake on innovation in the mass market to date. These include:

- **The economic environment.** Cutting across all other factors, the economic environment presents perhaps the biggest single barrier to innovation. A decade of unprecedentedly low interest rates has resulted in substantially lower guarantee rates and made innovation using guarantees both costly and challenging to market. COVID-19 has contributed to the likelihood of these challenges persisting for some further considerable time;

- **Consumer behaviour.** Inertia and loss-aversion and adverse perceptions of the pensions sector generally result in low consumer engagement and increase the risk of sub-optimal retirement income decisions;

- **Regulation.** The level and volatility of the Solvency II risk margin in the low interest rate environment, concerns around how conduct requirements may apply to innovative solutions, and limits to the support that organisations can provide to consumers without crossing the 'advice boundary' are posing particular challenges to innovation in terms of both cost and the risk appetite of organisations; and

- **Tax.** Due to its complexity and, in particular, the challenges consumers have understanding the impact of tax on their individual circumstances and chosen retirement income strategy.

As these factors all interact, no one factor presents the opportunity for a 'silver bullet' solution to create a more innovative product environment. Whilst the prospects for innovation would be maximised if there were shifts in each of these factors, any incremental changes could help facilitate innovation. A change in the current low interest rate environment may, however, create a bigger initial catalyst than other changes could on their own. That said, with interest rates having fallen further over 2019 and 2020, there is, at present, no obvious sign that the low interest rate environment will ease.

Future innovation

Looking to the future of the market, our research identified that:

- There is a role for product structures that combine flexibility and guaranteed income, although these are unlikely to develop for the mass market until the interest rate environment changes materially;

- A product, or portfolio of products, that can simplify the choice for consumers navigating complex retirement income decisions is key;

- There is a need to consider wealth as a whole rather than pensions in isolation in both advised and non-advised journeys. In particular, any comparison between the pension wealth gap and wealth held by many in property highlights a greater potential role for property wealth to support retirement income. This is likely to create a wider role for specific uses of equity release. It follows that there would be benefits in the equity release and pension markets operating as a more coherent retirement income market, both within the industry and at a regulatory level; and

- It is important that consumer engagement is increased whilst supporting the least engaged and vulnerable consumers in what is, by any standards, a complex, and for many, unfamiliar, area.

Incentives for innovation

Stepping back from the above, it is also worth asking what the incentives may be for innovation in the pensions sector, given the existing products that are currently serving the market. First and foremost, and as we discuss in the following sections of this report, the target market of the pensions sector, and its core needs, are changing fast. The growing population of over 65s[6] will lead to growth in an already significant retirement income market[7], and the accelerating shift from DB to DC pension savings will fundamentally change the way those consumers save for and consume retirement products. Consideration as to what new products are needed will become essential for organisations who wish to continue to compete in the retirement market, and will also be necessary to meet the developing expectations of regulators and policy makers.

There are, moreover, some clear product areas with potential for rising commercial success in the mass market, including hybrid product structures, a greater role for equity release in retirement planning, and other forms of longevity protection. It remains to be seen what innovation will occur; but if the pensions sector does not take up the baton, there is a clear risk that consumers move their money into other financial products outside the sector.

A landscape for innovation

Over the two decades leading to the introduction of pension freedoms in 2015, the UK pensions sector underwent substantial structural change as a result of the steady decline in employer based DB pensions and associated rise in DC pensions.

This trend was accelerated by the introduction of automatic enrolment. Over the same period, the attractiveness of the annuity, the then compulsory default product for all but the most affluent when accessing their pensions, steadily declined. This was driven by the falling nominal interest rates, and was eroded further as the real interest rate turned negative with the onset of the financial crisis.

These structural changes culminated in the sudden, and largely unanticipated, lifting of compulsory annuitisation which came into effect with the 2015 implementation of pension freedoms.

This combination of policy and economic change has had profound consequences for consumers saving for and in retirement:

- Increasingly, pension savers and pensioners are exposed directly to market risks, as pension pots in drawdown continue to fluctuate directly with the markets they are invested in;
- Greater flexibility in how to access pension savings has vastly increased the complexity of consumers' decision making, particularly when compared with the certainties of DB schemes, requiring consumers to make decisions and judgments on matters such as:
  - tax, which, if mis-understood or misjudged, can lead to potentially heavy tax erosion of pension wealth; and
  - personal longevity, which is a difficult area for non-specialists to grapple with – evidence suggests that most people underestimate their longevity significantly[8]; and
- Many consumers do not have practical access to financial advice, or do not make use of it. Here cost considerations and lack of awareness are powerful barriers.

There are a number of factors which interact to affect consumer needs, which come together to form a landscape for innovation in the retirement market. These are explored below.

Use of advice

It is generally accepted that there is an 'advice gap' in the market. This advice gap is driven by a number of factors, including access (and consumer engagement), cost, and the – actual and perceived – quality of advice[9]. As a result, consumers are often making complex decisions on a non-advised basis. As consumers tend to follow the path of least resistance at retirement[10], there is a substantial risk that many of these decisions may prove to be sub-optimal for the individual.

Levels of pension saving

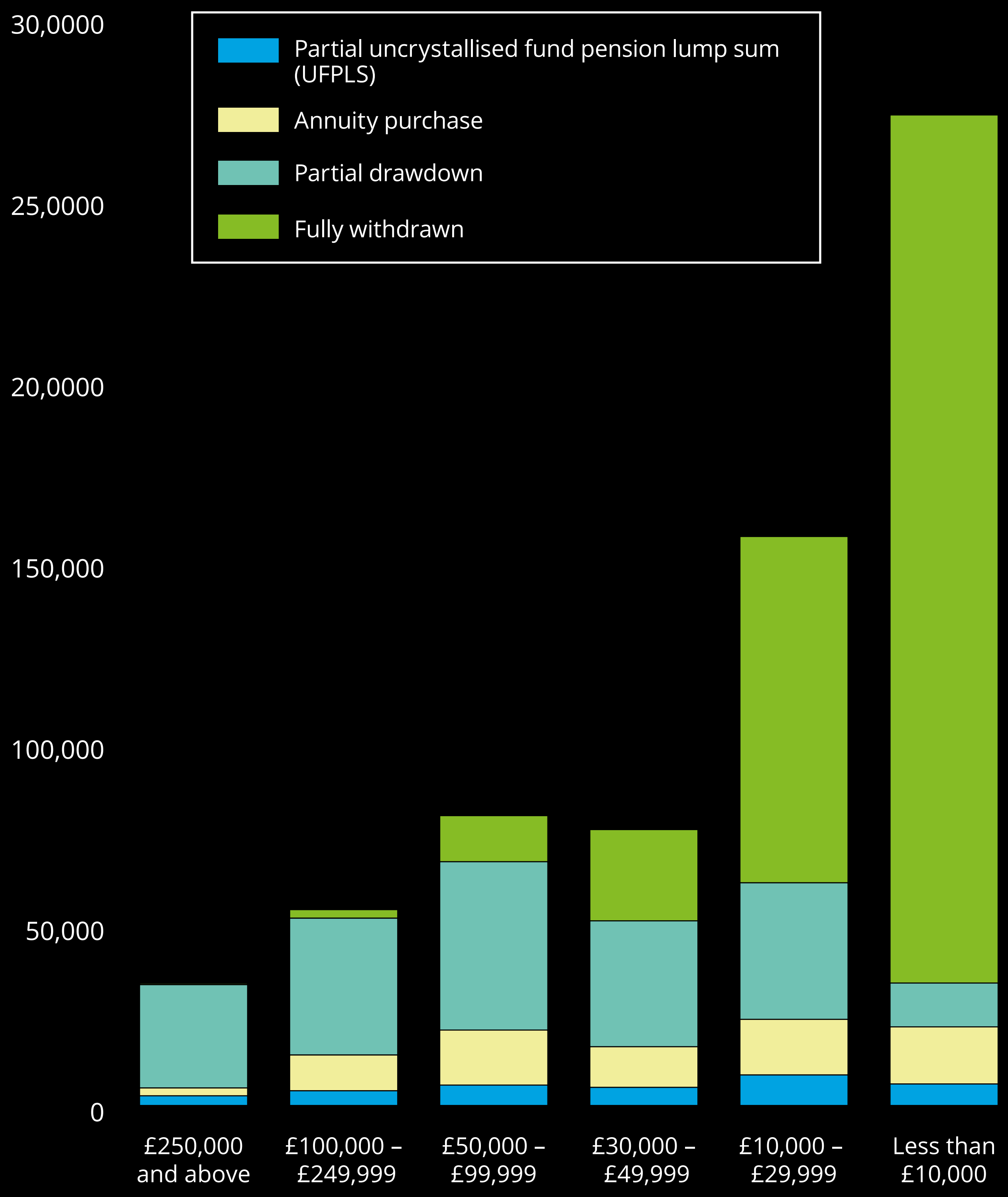
Consumers' ability to achieve good retirement outcomes is also limited by their levels of pension savings. To live comfortably in retirement, research indicates that a single consumer needs around £18,500/year, and therefore is likely to require pension savings in excess of £150,000 (assuming they qualify for the full State pension)[11]. However, around 70% of consumers currently aged between 50 and State Pension age have DC savings below £24,400[12] and DB entitlements below £7,000/year. This leaves a potentially considerable gap with the pension savings required to provide a level of income that many consider acceptable.

It is projected that the median DC pension savings will grow from around £27,000 (in 2017) to £59,000 by 2038[13]. However, this expected growth might fail to materialise fully, given the number of challenges – in particular, consumer behaviour.

Sources of pension wealth

The amount of DB assets in the UK is expected to shrink to less than a fifth of current levels of £1.5 trillion by 2043[14]. In terms of membership, as of March 2019 there were 1.1m active members remaining in DB pensions (excluding public sector employees), 5.1m deferred members and 4.5m pensioners. This compares to 2.4m active members in 2010, i.e. a fall of over 50% in less than a decade. In addition, only 13% of DB pension schemes remain open to new members[15]. Research suggests that less than 10% of retirees today retire with only DC savings, but that by 2060 this number could be up to 50%[16]. Recently-announced changes to the UK Retail Prices Index (RPI) are also likely to reduce the real value of future DB entitlements for those retiring with them.

Figure 1. Number of pension plans accessed in 2019/20 by pot size and method of access



Source: FCA, Retirement income market data 2019/20, 29 September 2020

This shift towards DC pensions carries the risk that consumers with lower levels of DB pensions could face a challenging financial situation in retirement. As noted above, 70% of consumers currently between 50 and State pension age have DB entitlements below £7,000/year and DC savings below £24,400[17]. In addition, 29% of 55-64 year olds and 42% of 65-74 year olds who have accessed their pension feel the money would be enough for them live on. 37% of those who have accessed their pension within the last two years expect the State pension to be their main source of income[18].

Choice of retirement products

Five years on from pension freedoms, annuities are no longer the dominant withdrawal choice for consumers accessing their pensions. Today a larger number of consumers are opting for drawdown products (see Figure 1).

This shift away from annuities means many consumers are now having to manage their own longevity and investment risk within their retirement income choices. This will become more important as exposure to DB pensions reduces.

This choice stands in some tension with the facts that:

- **72% of men and 81% of women rate having access to a guaranteed income for the rest of their life as important to them[19].**
- **70% of men and 79% of women believe having income that grows with inflation in retirement is important[20].**
- **74% indicated a real desire for flexibility in when and how they can access their money.**

Consumers' desire for both security and flexibility can potentially be in conflict[21]. Consumers are also inherently bad at predicting their own longevity[22] which makes this trade off increasingly challenging to manage.

The shape of retirement is also changing; for many, the traditional cliff-edge retirement is moving towards a phased approach. More than 42% of people intend to continue working after they retire and a further 9% intend to be self-employed[23]. This will result in income needs varying more through retirement, particularly when coupled with the potential need for later-life social care[24]. Overall longevity increases result in a longer retirement with more unpredictability as to what (and when) circumstances will arise.

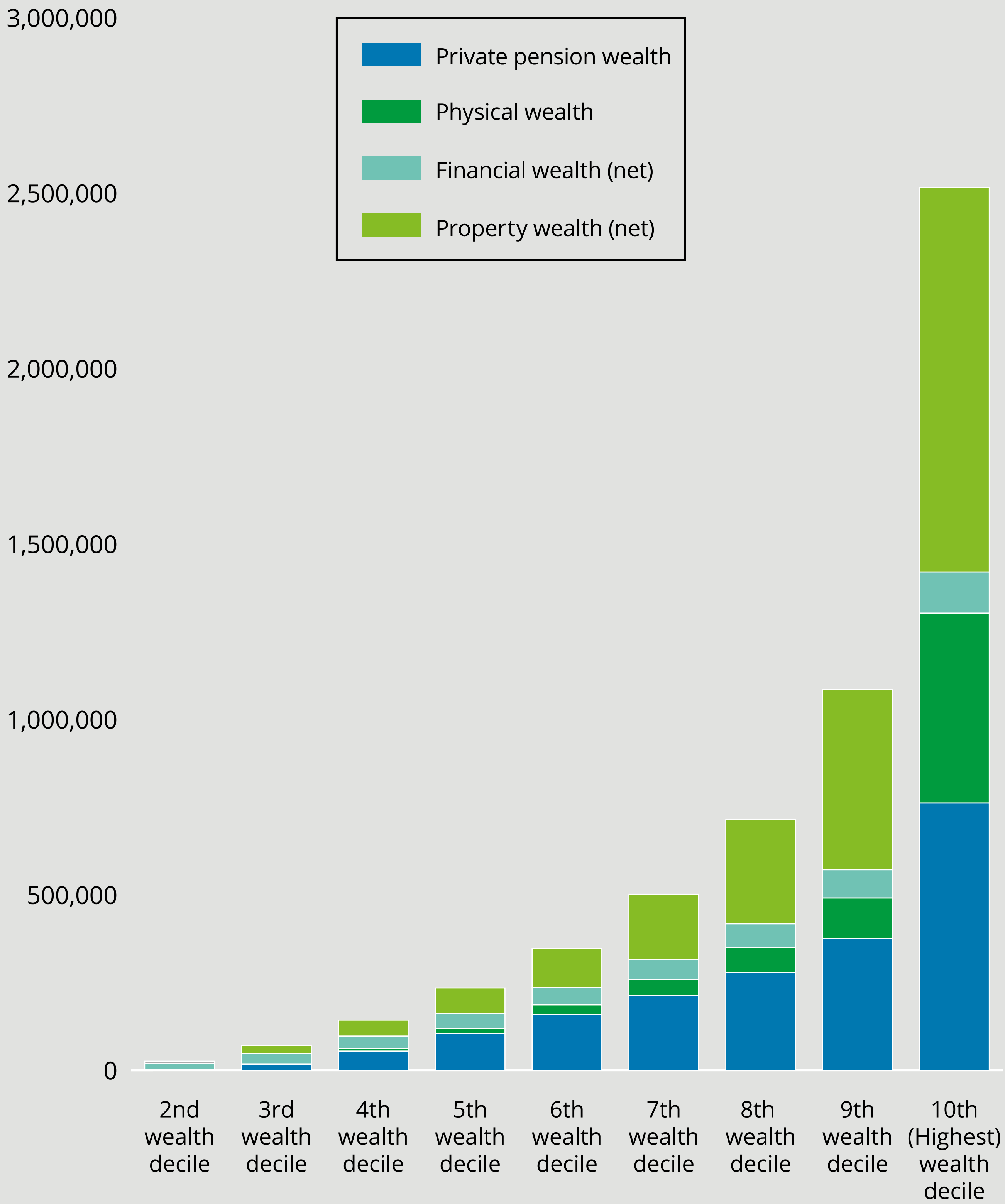
DB transfers

Alongside the changes to the way consumers access their DC pension savings, there has been a steep increase in those seeking to transfer out of DB pensions to DC pensions. In the six months to March 2016 5,056 transfers took place, and in the six months to March 2018 34,738 transfers[25] took place. Transfers have reduced from this high point (six months to September 2018: 32,488; six months to March 2019: 24,832)[26], but still represent a significant increase on previous levels. This is increasing the number of consumers using the new flexibilities to access their pension savings (which are not available for DB pensions). It is driven by a number of factors including a desire for flexibility but also the markedly increased transfer values, driven to a significant extent by low interest rates.

Sources of wealth

Private pension wealth is the greatest component of total wealth for consumers but this is unequally distributed across the population (see Figure 2). For the least wealthy 30% of consumers (1st to 3rd deciles), physical wealth[27] is the greatest wealth component. For the 40% of middle wealth consumers (4th to 7th deciles), property is the greatest wealth component. Whilst for the wealthiest 30% of consumers (8th to 10th deciles), private pension wealth is the greatest wealth component.

Figure 2: Breakdown of aggregate total wealth, by deciles and components



Source: ONS, Wealth in Great Britain Round 6: April 2016 to March 2018, 5 December 2019

Overcoming barriers to product innovation

Post pension freedoms consumers are managing their own longevity risk and investment risk. The probability of their getting that wrong and suffering poor outcomes will increase as the reliance on DC pensions increases. With the reduced popularity of annuities, organisations will need to consider alternative ways to meet consumers' needs for longevity protection and investment management. This sits alongside the greater need for flexibility.

In this section we explore the potential barriers that may exist to developing such products.

Consumer behaviour

Past regulatory scandals that have affected the UK retirement sector continue to resonate with consumers. Trust issues with DC pensions are predominately related to the perception that "the house always wins"[28] and, additionally, that organisations providing pensions are not always putting the interests of consumers first.

This lack of trust is exacerbated by the complexity of pensions. Retirement income is one of the most difficult financial decision areas a consumer has to grapple with. Studies show that by far the most prevalent associations with pensions are the words "complex" and "confusing"[29]. As such, only a small number of consumers are trying to learn more about their pension and can often find the process too difficult. The majority of consumers do not engage with their pension for many years, beyond receipt of the annual statement.

This complexity of pensions and the lack of trust reinforces a number of behavioural biases in consumer decision-making, most notably inertia and loss aversion.

Inertia

Consumers tend to rely on familiar assumptions and exhibit a reluctance and/or inability to revise those assumptions. This means that consumers display low levels of engagement with pensions, during both the accumulation and decumulation stage[30]. This is reflected in consumers' low switching levels between providers at retirement[31].

The highest risk of inertia (i.e. not saving for a retirement income) has been partially mitigated during the accumulation stage through the introduction of auto-enrolment. This also means, however, that, once enrolled, consumers make few active changes to their contribution rates or investment mixes. As such, consumers tend to select 'the path of least resistance' – in effect, making the easiest, rather than necessarily the best, decision throughout accumulation and decumulation.

Loss-aversion

Consumers prefer avoiding perceived losses to acquiring equivalent gains. In the case of retirement income, this has resulted in consumers exhibiting a low appetite for annuities post pension freedoms. This reflects a common perception that the product is poor value in terms of income generated and involves the unfair 'loss' of a pension pot to the provider. Consumers may worry about potential losses to heirs in the event that they die early, since annuitisation usually eliminates the possibility for bequeathing these funds. However, this lower appetite for annuities has also been driven by the negative real interest rate environment which has accentuated the perception that annuities do not offer good value.

Additionally, as noted earlier, consumers tend to underestimate how long they are likely to live and consequently undervalue the benefit of saving for retirement and the longevity protection that annuities provide. This is one bias that could see reinforcement as a result of perceptions of risks to longevity created during the COVID-19 pandemic. Such an asymmetric valuation enhances the probability of consumers taking their pension accruals as a lump sum rather than buying a lifetime annuity.

In short, many consumers tend to be overwhelmed by the decision to annuitise[32]. The above behavioural biases result in low consumer engagement and therefore risk sub-optimal retirement income decisions. These are reflected in consumers' preference for lower risk assets such as cash. In turn, this lowers organisations' appetite for product innovation due to the lack of buy-side demand.

Pricing and Capital

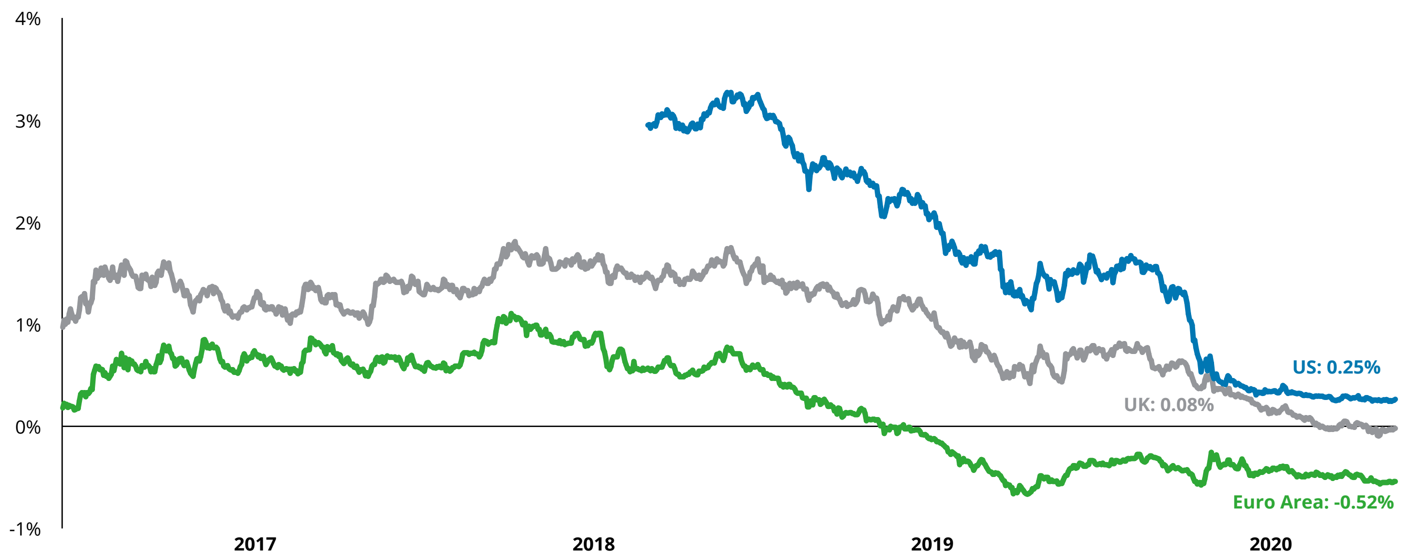
The prolonged low interest rate environment is widely considered to be the most significant factor driving current prices of guaranteed income products, and one that is unlikely to change in the short term (see chart below), especially given the economic challenges resulting from COVID-19.

This environment has coincided with a period of overall improving longevity, which also increases the price of income guarantees. In addition to the limited returns available on insurers' investments backing income guarantees, many in the industry view the level of the Solvency II risk margin (which is a major driver of the cost of capital for longevity risk) as a barrier to providing a guaranteed income at a price that consumers would perceive as offering value[33]. This is particularly the case for deferred guarantees, where reinsurance may be more expensive.

The Prudential Regulation Authority ('PRA') has indicated clearly that it would like to change the implementation of the risk margin in the UK[34]. The risk margin is also one of the topics to be considered in a UK government review of certain features of Solvency II, on which HM Treasury launched a call for evidence in autumn 2020[35]. EIOPA has also indicated[36] that it is exploring options to reduce the size and volatility of the risk margin in the context of its work on the 2020 Solvency II review. Changes to the regulatory framework that reduce the interest rate sensitivity inherent in the current risk margin methodology, so reducing the capital volatility and cost of providing fixed rate guaranteed pension products, could remove one of the barriers to innovation we have identified.

However, there are also a number of possible management actions and approaches open to insurers to make guarantees more affordable from a cost of capital perspective and hence ultimately to consumers. Many insurers have already undertaken a programme of capital optimisation, for example through traditional longevity reinsurance and the use of the Matching Adjustment, while applying the transitional measure on technical provisions to cushion the impact of Solvency II on annuity costs in the interim. We outline some further key areas for consideration at a high level on the next pages.

Figure 3: Expected 3m interest rates by December 2020



Source: Refinitiv Datastream

Improving the quality and use of data

Data limitations and quality issues are a perennial problem for insurers. Alongside associated model risk allowances, this may necessitate greater margins of prudence in assumptions relating to reserving, capital and pricing. Addressing data issues may allow insurers to reduce margins of prudence, allowing for more accurate reserving, capital modelling and pricing. Whilst this may not have a material impact on pricing in and of itself, greater capital efficiency is likely to result from the cumulative impact of a number of potential approaches. However, solving this issue may require significant investment and will not be without difficulty in some cases.

Drawing on wider data pools may also allow better insight into and modelling of insurers' consumer base and associated longevity risk exposure, and hence improved underwriting and reserving. Examples of new data sources that insurers could use include health and lifestyle data (for example from wearable technology) and data about what consumers buy (for example, groceries). The treatment and governance of such data will require care and consumer understanding of and consent to its use. However, consumers may well be willing to share more data as a way to achieve better pricing.

Capital Markets and securitisation

In contrast to the buoyant longevity reinsurance market, the transfer of longevity risks to the capital markets is relatively limited. Factors driving this include the long-term nature of the risk, or a lack of access to sufficient pricing data, and expertise (particularly for more tailored instruments of hedging programmes).

However, capital markets instruments could, in theory, be structured to mitigate individual insurer's longevity risks while offering diversification against traditional market risk. Additional benefits for insurers may also include reducing reinsurance concentration risk. Some examples of the instruments that could be used include:

- Longevity spread bonds (limited use to date);
- Longevity swaps;
- Mortality (Q) and/or survivor (S) forwards; or
- Bull call spread options to provide tail risk protection[37].

Innovative use of reinsurance

Further innovation may also be possible for reinsurance, for example increased use of reciprocal reinsurance between insurers with diversifying risk types. Various factors would need to be addressed for this to occur, albeit these do not appear to be insurmountable, for example:

- Regulatory permissions;
- Modelling capabilities for the risks taken on;
- Risks to sensitive proprietary information; and
- Potentially, a suitable platform for intermediating and managing such transactions.

Conduct Regulation

The Financial Conduct Authority ('FCA') has been and will continue to be heavily focused on the at-retirement market, recognising the changing landscape and consumers' higher propensity to vulnerability resulting from an ageing population[38]. Whilst the COVID-19 pandemic has caused some delays to implementing some changes in the retirement market, the focus remains and will continue as the FCA regains business as usual focus. Changes in the regulatory environment can, in practice, either support or act as a brake on innovation. However, based on our research, there are some regulatory changes, discussed below, that could open opportunities for innovation in product development while supporting the FCA's consumer protection objectives.

Disclosures

Pension products and the decisions associated with them are very complex for mass market consumers. Whilst it is possible to use a pension to buy a mix of products, this is not common in the mass market. As such, the non-advised disclosure requirements are largely geared towards a binary product choice. If new mass market products are to be offered without advice, the disclosure requirements would benefit from being revisited. Specifically, clarity on how these should apply to products that combine flexibility and secure income would be required.

In particular, consumers' information needs will differ from those where the product choice is binary, as the two product elements would need to interact rather than operate separately. This may require, for example, a different approach to illustrations. Under the current regime, there would be a risk of information overload if disclosures for both drawdown and an annuity had to be replicated for a hybrid product.

Investment Pathways

The FCA has commented on the lack of products for the mass market that combine flexibility and security; a likely candidate to meet this is a hybrid pension product that combines a guarantee within a drawdown structure (see the next section for more details).

Following the FCA's final rules on investment pathways[39] there is possible further, actual or perceived, challenge to offering non-advised hybrid products. Investment pathways would apply to most non-advised hybrid structures, which utilise drawdown structures as the base. Where a hybrid structure includes a later life guarantee purchased from part of these drawdown funds (see option one in the Appendix for more details) the investment selection for that proportion of the drawdown funds would need to align assets to match guarantee rates as the date of purchase nears. This would likely involve a higher exposure to cash or cash-like assets in the same way as lifestyling for an annuity purchase would do.

The FCA's requirement that consumers cannot be defaulted into pathways or investments with over 50% exposure to cash or cash-like assets could present a challenge for some hybrid structures being offered without advice. As such it would be helpful if the FCA could clarify how it would anticipate investment pathways operating for hybrid product structures; for example, if it would treat the product selection itself as an active choice of fund under its rules.

Advice gap and boundary

Many organisations would like to offer more detailed support to their consumers, recognising the complexity of the decision to access a pension and the risks that come with making an incorrect decision. However, most organisations we spoke to expressed concerns about crossing the advice boundary. This is an ongoing area of challenge and there will be limits on how far the FCA is able to go under the current legislative framework.

Many organisations also perceive that products and journeys could be more tailored to consumers' needs if the advice boundary were clarified. The use of tools to support consumers through the decision making process and the use of data to tailor the guidance given to consumers could be areas of clarification.

Additionally, further work could be done within the advice sector to reduce the cost of advice for consumers, to help overcome one of the main reasons why many do not seek advice. This will require the use of automation to support the lowering of the cost of the advice and to assist risk management. Most of those we interviewed do not believe that human interaction will be replaced in the retirement advice journey in the immediate future. Rather, they see technology as supporting a more efficient, risk managed advice process[40]. Over the longer term, however, as different generations retire and technology improves, this may change.

The COVID-19 pandemic has already started to accelerate changes to the traditional face-to-face advice model and, as a result, technology and more accessible advice models may become the norm sooner than they would otherwise have done with more organic business model shifts.

Tax

The UK tax regime poses a barrier to retirement product innovation due to the challenges consumers have in understanding the impact of tax on their individual circumstances when accessing pensions. This is particularly the case for consumers who do not benefit from financial advice.

Consumers need to understand both how the tax regime allows money to be accumulated and taken – and how the tax free element applies – and how their marginal rate of income tax could change through the way in which pension income is drawn and phased. Inheritance tax ('IHT') adds further complexity: for example, drawing cash from a pension (where it is typically outside the IHT regime) could bring it within the regime. Another concern of consumers is the perception that the pension tax goal posts have changed a lot, creating a perceived need to act before options are taken away. This is often in the context of pension freedoms or taking tax-free cash, and may lead to sub-optimal decisions.

These complexities make tax a challenge to organisations offering products to the mass market on a non-advised basis. They need to ensure consumers understand the potential tax implications of their decisions but also avoid straying into giving advice to those consumers. Some organisations have developed online tax calculators for their consumers to use to get an estimate of the tax impacts of their decisions. These tools are useful for consumers if, or to the extent, they choose to use them. But even where they do, the limitation to online interactions potentially excludes some consumers, especially those who may be vulnerable.

The FCA[41] has already asked Government to consider decoupling the decision to take tax-free cash from the decision to move into a decumulation product. The purpose is to drive better consumer decision making. This would require legislative change and it is not yet clear if this is likely to be pursued.

A simpler pension tax regime would potentially aid consumer decision making and create an environment in which innovation was more likely to succeed. However, change may risk greater complexity unless there is a major simplification of the regime as it applies to pensions access. Such a simplification seems unlikely at the present time. Further, any change that resulted in an actual or perceived reduction in benefits to consumers accessing their pensions could well have a negative impact on consumer behaviours, and so would need to be carefully managed.

Potential opportunities for mass market innovation

While the needs of consumers vary, there are a number of areas where consumers need to manage risks through their product selections, namely:

- Longevity risk and the length of retirement;
- A pension pot that may be sub-optimal in size;
- Tax; and
- Investment and inflation risk.

Given the complexity of consumers' needs there is a potential space in the mass market for products that enable consumers to achieve multiple aims within the same wrapper or using a portfolio of products that work together. These approaches would clearly come with potential conduct risks that need managing, particularly on a non-advised basis.

No one product (including those illustrated in this report) offers the solution to all consumers' needs or the challenges they may face. Rather, each of these products can potentially support a well-functioning retirement market that can meet a range of consumer needs in the changing face of retirement.

We outline below some areas where we consider, based on our research, the mass market may evolve over time.

The workplace pension market

From our discussions, some market participants are of the view that innovative approaches to retirement income products may first arise in the trust-based workplace pension environment under The Pensions Regulator ('TPR') regime. Trustee duties are to look at members as a whole (which may allow more standardised outcomes to be delivered) and different prudential requirements arise as a result.

As a result of the many millions of auto-enrolled members of DC master trusts, there is likely to be substantial latent consumer demand for retirement income products from master trusts that may have to be delivered under the TPR regulatory regime, unless consumer inertia can be overcome. Some of these master trusts are also not for profit organisations.

We are seeing that master trusts are now considering how to cater for their members' needs at retirement, in some cases having launched drawdown products, and we expect this to be a developing area in the immediate future.

However, this also gives rise to the potential scope for collaboration between the trust-based workplace pension sector and the commercial pension sector to deliver joint solutions through workplace pensions.

Hybrid product structures

With consumers needing a combination of investment growth, flexibility and longevity protection, it is important to consider the role of hybrid product structures for the mass-market. The FCA has specifically raised the lack of products that combine flexibility and guarantees in their work in this market[42].

The reasons these products are not currently offered for the mass market on a non-advised basis are largely the barriers set out in the preceding section. As such, the market environment will need to change in a number of ways to enable these products to be launched for the non-advised mass market. In particular, the interest rate environment changing and the regulatory and Pensions Guidance regime supporting a non-binary product choice will be key in creating the environment for these products.

Any organisation offering a hybrid product to the mass market will need to ensure simplicity in how the product operates and can be explained to a consumer, and manage any conduct risks. The key conduct risks that would need consideration in developing hybrid products for the mass market include:

- Complexity of the product design and appropriateness for target market;
- Clear definition of target market and ability to ensure (and monitor) that it is sold to this group;
- Disclosures and how these interact between flexibility and guaranteed elements;
- Ability to manage changes in circumstances and vulnerable consumers;
- The risk of information overload preventing consumers from engaging with the risk disclosures and product choices.

Organisations should approach these products with simplicity and vulnerable consumers at the heart of their thinking in designing communications, and in distribution and policy administration processes. There will be key parts of the consumer journey where consumers may have a higher propensity to be vulnerable – for example, if changing the way they intend to access their plan due to a change in circumstances – and this should be built into the way processes are designed to support consumers through these journeys.

Most organisations we interviewed believe there will be a role for hybrid products in the retirement income market in the future. However, there are mixed views as to whether the market is ready for these products now. Some organisations have explored the introduction of hybrid product structures but had been unable to make them work at this stage. Reasons given for these products not being likely to be successful at the current time include:

- Guarantee pricing, largely driven by the low interest rate environment;
- The need to invest in engagement and technology being a greater immediate need; and
- The complexity of disclosure requirements for these products meaning they would be hard to market to the mass market at present.

We have identified three potential hybrid product structures and consider the benefits, risks and challenges associated with each in the Appendix to this report.

Longevity risk products

The retirement income market is not just made up of insurers but also wealth managers and master trust providers who may find it difficult to offer longevity protection themselves. This presents, in our view, a clear opportunity for longevity insurance products that could be 'wrapped' around other providers' pensions. This would allow non-insurance pension providers and advisers to potentially replicate the economic effects of hybrid products without having to offer all of the features themselves.

As with hybrid products, the key to success will be simplicity so that the combined product structure does not become too complex to understand. The disclosures required will need careful consideration as these structures are likely to be considered two products. Collaboration with the FCA may be required to find an optimum disclosure solution.

The expected greater ability to shop around that these products could provide, when compared to hybrid products, may also create greater competition in the market resulting in improved rates being available. This may also allow consumers and advisers to take advantage of underwriting for health and lifestyle conditions. However, given the current smaller scale of the annuity market this is unlikely to develop to the scale of the pre-pension freedoms annuity market.

Releasing property wealth

Not all consumers use pensions as their primary savings vehicle for retirement; property is another common vehicle for retirement planning. Even where consumers do not make an active decision to use property as a vehicle for retirement planning, for many in the mass market property will be their largest asset in retirement.

Many consumers will be faced with inadequate pension savings for retirement but significant property wealth in comparison. The need to access property wealth may come from a variety of triggers, some related, for example, to inheritance planning, and some to immediate financial needs. However, an obvious challenge is how to access this property wealth when it resides in the property in which a consumer lives. Equity release products seek to address this challenge by lending against accumulated equity while the homeowner continues to live in their home.

Equity release is an advised product. It has faced much criticism in its history linked to extremely poor outcomes experienced by many consumers who purchased equity release products in the 1980s and 1990s. Equity release mortgages sold today, however, bear little resemblance to these products, with the 'no negative equity guarantee'[43] incorporated into all products providing important protection for the consumer.

Equity release is, nonetheless, a complex product that may give rise to a number of potential conduct and prudential concerns (for example, whether the consumer adequately understands the costs of the product, including the compounding nature of the interest)[44]. Whether, and if so when, to use equity release will therefore vary by consumer and objective, and it is not possible to generalise about the role it might play in all circumstances. Whilst for many, downsizing may be the right decision, for others this will not be an option or would not meet their objectives. For example, passing on funds to heirs while still living would not necessarily be consistent with downsizing or downsizing might not release sufficient money to meet the needs of the consumer. As a result, it appears that there is a role for such products. It is therefore important, in our view, for discussion to take place on the role of equity release in retirement income and the challenges that may need to be overcome to ensure this meets the needs of mass market consumers.

Key areas for consideration include:

- Products that allow consumers to draw down from a pre-approved pot (and only pay interest on what is drawn) are likely to support more consumers' aims. This is also likely to reduce costs for consumers in respect of interest compared to drawing down all funds at inception. Whilst these products do exist today, these may need to become more mainstream in the future alongside other structures such as those that provide a regular income stream;

- Consideration needs to be given to how property wealth is considered alongside pension, and other wealth, both through advice and pensions guidance. A consumer navigating retirement income without advice will generally find that support is directed towards decisions with specific assets rather than taking a holistic view. There is also a question as to how, in the future, the pension dashboard may need to consider this element of a consumer's wealth;

- There is a need for the equity release and pension markets to start operating as a more coherent retirement income market, both within the industry and at a regulatory level;

- When advising on equity release advisers may need to consider other sources of wealth to ensure optimal consumer outcomes. This may require some advisers to up-skill if they are not currently trained to advise on those other wealth sources;

- The cost of equity release remains an important factor and therefore value for money will likely face increased scrutiny as equity release grows in popularity. Organisations will need to consider how they will assess whether their products offer value for money in the context of the changing role of equity release and the risk they take on; and

- As the role of equity release grows, it is important that the industry manages the conduct and customer outcome risks associated with it. Disclosures of costs and charges and the risks and obligations (including continued maintenance of the property to a contracted standard) being taken by consumers will all be key elements of this.

It is also worth noting that equity release offers an opportunity for insurers offering longevity guarantees to mitigate the capital costs of these products through the Solvency II Matching Adjustment ('MA'). There has been a significant amount of PRA scrutiny in relation to how the risks of the no negative equity guarantee are captured in insurer's capital and solvency. However, the capital benefits for organisations offering both sets of products potentially benefit consumers through both choice and pricing.

The role of collective DC

Following its consultation[45] on collective DC, the Department for Work and Pensions is seeking to pass legislation to permit Royal Mail to set up the first collective DC scheme in the UK.

Whilst collective DC is popular in some jurisdictions, such as the Netherlands, it is not a concept that currently exists in the UK market. However, both the Government and some respondents to the consultation believe it may have a role in achieving better retirement outcomes in the UK market.

Advocates of collective DC argue that it offers an opportunity to pool longevity and investment risk in a way that is less risky for employers and trustees than DB pensions. It offers certainty of liability but the ability to invest on behalf of the members as a whole could result in members of collective DC schemes getting more income in retirement than with a typical DC pension. The scale of this benefit to consumers depends on a number of factors and there is currently no view on what a wider collective DC market would look like in the UK. It is important to note that the application of collective DC in the UK is likely to differ to other jurisdictions where this has been successful, for example in the Netherlands where even DB pensions do not have 'hard' guarantees like in the UK.

The challenges in launching a successful collective DC scheme in the UK include obtaining the required scale and balance of membership between generations to ensure the cross-subsidisation model works effectively. This would require an active scheme that will remain in existence for a long period and some single employer schemes may struggle with this. It also requires buy-in from members joining the scheme as they will effectively be sharing longevity and investment risk with the other members, including across current and future generations, and if one generation seeks to exit the model will cease to work.

Additionally, and one of the greatest concerns about collective DC in the UK, is the need for members to understand this alternative type of pension and the fact that any targets are not guarantees. Lessons regarding member expectations could be taken from the with-profits market in this regard given the similarities in the products' structures.

Collective DC may have a role in the UK but may need to take a different form than in other jurisdictions. It is likely to form only one part of the retirement market, possibly in the master trust space. It will be some time before collective DC could be a mainstream part of retirement planning in the UK and further legislative change beyond that planned by DWP will be required for this innovation to be permitted more widely in the UK market.

Conclusion

The introduction of pension freedoms in 2015 created significant expectations about the potential for product innovation in the UK retirement market. To date, however, there has been limited product innovation for the non-advised mass market other than the arrival of non-advised drawdown products. That said, the industry has focused its attention on how it can innovate at each stage of a consumer's "journey" to increase consumer engagement.

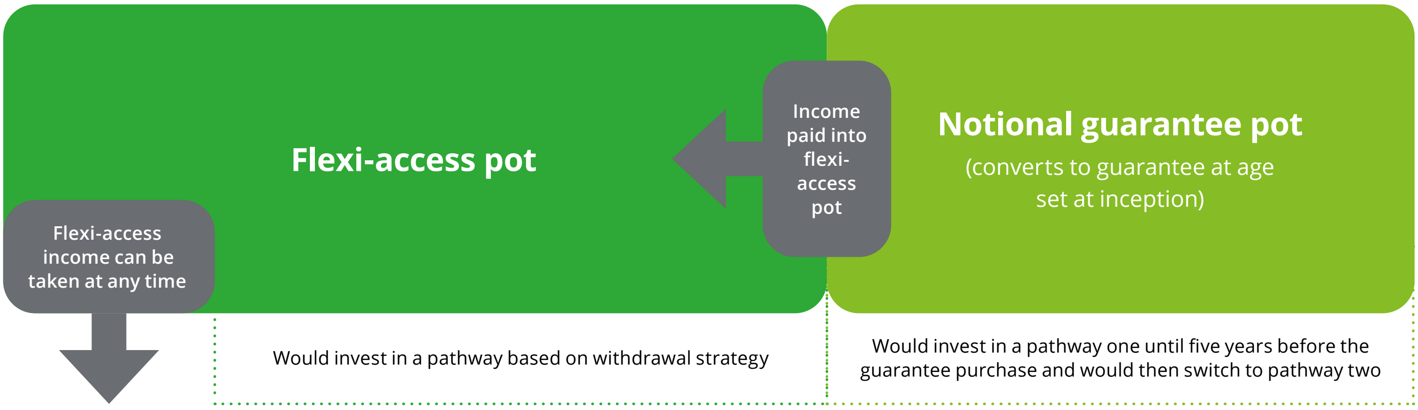
Notwithstanding the inter-related challenges and barriers covered in this report, we think that product innovation for the mass market can – and is likely to – materialise in the future. Innovating in this market will be not be easy, being made even harder by the COVID-19 pandemic, and the challenges identified in this paper need to be addressed. Nevertheless, innovation is ultimately likely to be driven by increasing consumer need as the shape of the pensions market evolves towards greater DC reliance. Consequently, if firms wish to remain competitive in the retirement market they will need, increasingly, to respond imaginatively and flexibly to this innovation challenge.

There is a role in the retirement income market for products that combine flexibility and guaranteed income. Products that can simplify the choice for consumers navigating complex decisions about retirement income are key; well-designed, simple hybrids could potentially deliver this. Further, in retirement planning and strategies, there is a need to consider wealth as a whole rather than focusing on pensions alone. Specifically, there is a greater potential role for property wealth to support retirement income due to the pension wealth gap when compared to the wealth held by many in property and this is likely to create a wider role for targeted uses of equity release where consumers' individual circumstances support this.

Product innovation does not sit in a vacuum and it is important that consumer engagement is increased while supporting the least engaged and vulnerable consumers through what are, inherently, complex and high impact retirement income decisions. As such, different stakeholders across the industry – organisations, regulators, consumer bodies and the Government – will each have an important role to play in delivering both the innovation that consumers will increasingly need and the consumer engagement that, in turn, is necessary for this innovation to succeed.

Appendix – illustrative hybrid product structures

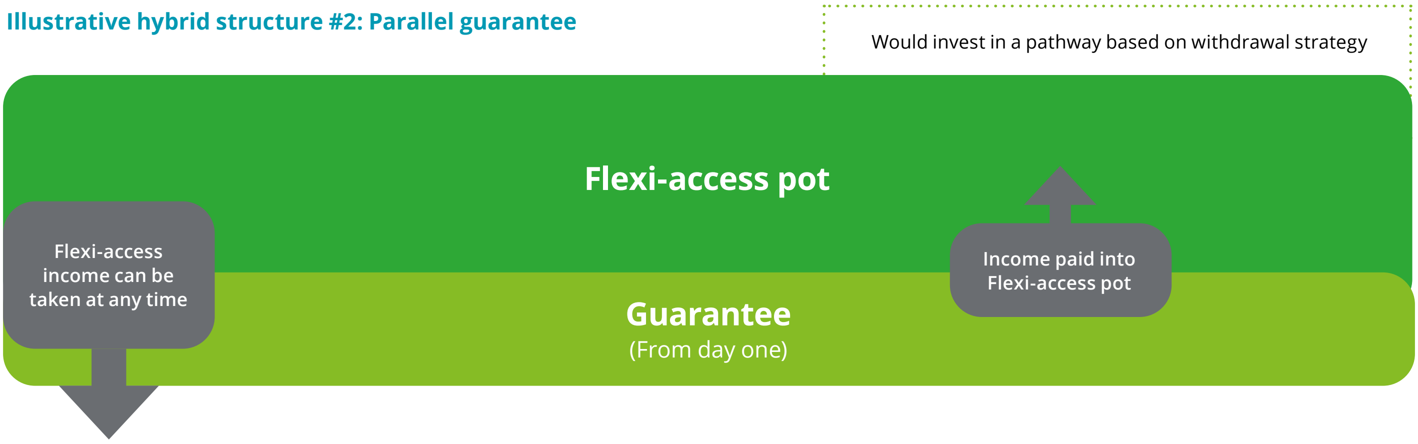
Illustrative hybrid structure #1: Later life guaranteed income[46]



Feature	Key benefits for consumers	Key benefits for organisations	Key challenges and risks
GUARANTEE • **Later life guarantee** • **Can include a deferred purchase a short period ahead of payment to secure rates** • **Until purchase a notional pot is set aside for the guarantee purchase which can be accessed if required** • **Date for guaranteed income set at start of product but the rate is not (date can be changed)** • **Guarantee sits in drawdown wrapper and income paid into flexi-access pot to manage tax and income needs**	• Provides security at a time when many consumers will need it and when income needs may have stabilised • Health and lifestyle conditions are likely to be more prevalent at a later age which can result in more accurately priced guaranteed income • Later purchase means that if a consumer's circumstances change they can use the notional guarantee pot flexibly as they are not locked into the guarantee until it is purchased at a later date • Active decision is needed to use the notional pot prior to guarantee purchase • Ability to change the guarantee purchase date if circumstances change • Single product decision is required to get a combination of flexibility and security • Can support a phased retirement	• Less capital intensive if carrying less longevity risk (separate challenge for deferred purchase) • Setting a date for the guarantee purchase at the outset allows communications to be tailored accordingly over the life over the product • Product operates like a flexi-access drawdown and then an annuity at a later date so may offer operational benefits	• Rate of the guaranteed income is not set until the purchase at a later date and so will be subject to changing guarantee rates – consumers will need to understand this and organisations will need to communicate the rates clearly • Consumers may benefit from shopping around for the guarantee and consideration will need to be given as to how the market can facilitate this • Organisations will need to consider health and lifestyle conditions and ensure appropriate dialogue with consumers on this issue – if not offered will need to consider how to ensure consumers with health and lifestyle conditions consider an enhanced annuity purchase instead • Organisations will need to ensure that within processes the two elements of the product operate together and the consumer sees an integrated view • The same risks that apply with annuities will apply to the guarantee purchase journey and consumers will need strong communications around that decision point • If offering a deferred annuity option there could be more challenging capital requirements under the risk margin and reinsurance may be more expensive or not as available

Feature	Key benefits for consumers	Key benefits for organisations	Key challenges and risks
FLEXIBILITY • **Flexi-access pot can be accessed in any way the consumer likes** • **The notional guarantee pot can be accessed if required but active decision required**	• Provides flexibility when many consumers will need it in the early stages of retirement • Allows consumers to flex income over time and phase retirement • If income is being paid and is not needed it can remain in the flexi-access pot until required (this can be used to manage tax liabilities also) • Can extend level of flexi-access by reducing notional guarantee pot if required	• Low capital intensity for the drawdown product base	• Ability to dip into the notional pot intended for the later life guarantee purchase could mean the money available for the later life guarantee is reduced over time and may cease to meet needs/expectations • Consumers will need to understand that extending flexible access to the notional guarantee pot will affect the size of the guaranteed income • Sustainability of income and tax liabilities are risks that consumers need to manage and organisations need to ensure robust disclosures/processes for
INVESTMENTS • **Investment pathways for non-advised** • **Lifestyling approach for notional guarantee pot (de-risking as near purchase date)** • **Flexi-access pot invested according to consumer objectives**	• Access to investment pathways for non-advised • Ability to grow pension pot prior to purchasing the guaranteed income and whilst taking flexible income	• Money remains invested • Can offer same/similar investment options to flexi-access drawdown products	• Need to manage different investment strategies for the notional guarantee pot and the flexi-access pot • Consumers will all have different strategies for the flexi-access pot and so identifying a default pathway may be challenging • Regulatory clarity required regarding the ability to transition to cash without further explicit consent (beyond the product selection) as the guarantee purchase date nears • Where a lifestyling type strategy is undertaken for the guarantee pot organisations will need to consider and manage the conduct risk associated with this

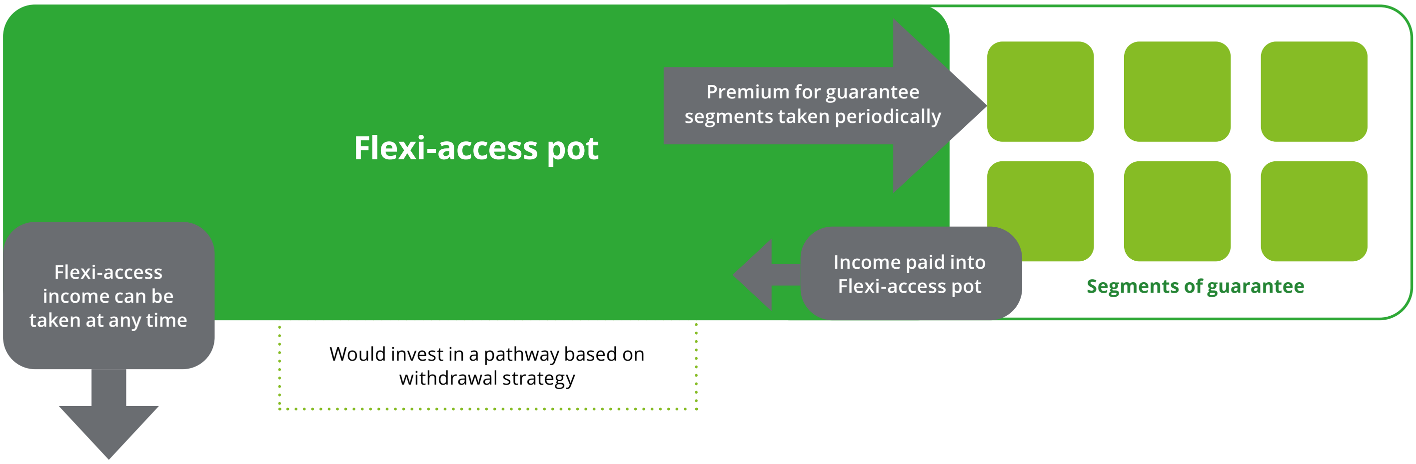
Illustrative hybrid structure #2: Parallel guarantee



Feature	Key benefits for consumers	Key benefits for organisations	Key challenges and risks
GUARANTEE • **Immediate guarantee is purchased with part of the pension fund** • **Guarantee sits in drawdown wrapper alongside a flexi-access pot** • **Income from guarantee is paid into flexi access pot to manage tax and income needs**	• Provides a base level of secure income throughout retirement • Health and lifestyle conditions can be factored into guaranteed income at point of purchase which may provide a higher income • Guarantee rate is known by the consumer at the outset so there is no uncertainty as to what it might be • No risk the consumer will 'over-spend' and have insufficient funds to buy the guarantee at a later date • Structure is simple to understand with more limited decision points whilst offering flexibility and security in one product • Can support a phased retirement	• Certainty of liability and capital requirements • Administratively is the same as an annuity and flexi-access drawdown	• Consumer is unable to change their plans with the guarantee if circumstances change • Guaranteed income per period may be lower than if the consumer waited to when they were older • Organisations will need to consider health and lifestyle conditions and ensure appropriate dialogue with consumers on this issue – if this is not offered will need to consider how to ensure consumers with health and lifestyle conditions consider an enhanced annuity purchase • Health and lifestyle conditions may be less likely to be known at date guarantee income is taken out • Consumers may benefit from shopping around for the guarantee and consideration will need to be given as to how the market can facilitate this • Organisations will need to ensure that within processes the two elements of the product operate together and the consumer sees an integrated view • The same risks that apply with annuities will apply to the guarantee purchase journey and these will need managing • Capital will align to that of an immediate annuity and this would need managing through reinsurance or other techniques

Feature	Key benefits for consumers	Key benefits for organisations	Key challenges and risks
FLEXIBILITY • **Flexi-access pot can be accessed in any way the consumer likes** • **Guarantee is locked in once purchased**	• Provides flexibility throughout retirement to increase income from a base level • Allows consumers to flex income over time and phase retirement • If income is being paid and is not needed it can remain in the flexi-access pot until required (this can be used to manage tax liabilities also)	• Low capital intensity for the drawdown product base	• No ability to widen the flexi-access pot and reduce the level of guarantee if circumstances change • Sustainability of income and tax liabilities are risks that consumers need to manage and organisations need to ensure robust disclosures/process for
INVESTMENTS • **Investment pathways for non-advised** • **Flexi-access pot invested according to consumer objectives**	• Access to investment pathways for non-advised • Ability to grow part of the pension pot	• Some of the money remains invested • Can offer same investment options to flexi-access drawdown products	• Consumers will all have different strategies for the flexi-access pot and so identifying a default pathway may be challenging • Risks largely as with non-advised drawdown with the addition of the fact the pot cannot grow before purchasing guaranteed income

Illustrative hybrid structure #3: Phased guarantee purchase



Feature	Key benefits for consumers	Key benefits for organisations	Key challenges and risks
GUARANTEE • **Later life guarantee** • **Purchase of guarantee is phased into segments so during every period a premium is taken from the pension and a segment of deferred guaranteed income is purchased** • **Until each segment is purchased the money sits in drawdown** • **Date for guaranteed income set at start and cannot be changed once segments are purchased** • **Segments can be paused or stopped if circumstances change** • **Guarantee sits in drawdown wrapper and income paid into flexi-access pot to manage tax and income needs**	• Provides security at a time when many consumers will need it and when income needs may have stabilised • Flexibility provided by the phased purchase of the guaranteed income as the consumer can stop purchasing segments if circumstances change • Rate of guarantee is locked in with each segment purchase which may provide more certainty that waiting until a later date to buy the whole guaranteed income and may act to 'smooth' guarantee rates over time	• Phasing of the guarantees and derivation of the guaranteed income may be capital advantageous • Only managing one investment pot/strategy which may reduce risk	• Likely to be very complex for a consumer to understand and therefore may not be suitable for a non-advised distribution • Communicating different guarantee rates on different segments will be challenging • Ability to shop around for each segment of guarantee may be limited in the market due to size and this may result in consumers' receiving a lower income • May be challenging to offer underwriting for health and lifestyle conditions on each segment due to the cost implications and this may mean consumers with health and lifestyle conditions – or at risk of them – would not be an appropriate target market • Guarantee rates may change negatively over time and this may be difficult to manage in terms of consumer expectations and understanding • Monies for the purchase of the guarantee are not segmented so a consumer could over-spend earlier in retirement and not have sufficient funds to purchase all intended guarantee segments – this could happen more passively than with option one • Each segment is likely to be small and there would be cost implications of managing these • If deferred guarantees are used the earlier purchases of segments may be less capital advantageous due to the risk margin and the availability of reinsurance • Date for payment of the guarantee will be harder to change once the purchasing of segments begins – this date may no longer be appropriate for a consumer and may result in outcomes that are no longer the best for them

Feature	Key benefits for consumers	Key benefits for organisations	Key challenges and risks
FLEXIBILITY • **Flexi-access pot can be accessed in any way the consumer likes** • **Guarantee is locked in once purchased**	• Provides flexibility throughout retirement to increase income from a base level • Allows consumers to flex income over time and phase retirement • If income is being paid and is not needed it can remain in the flexi-access pot until required (this can be used to manage tax liabilities also)	• Low capital intensity for the drawdown product base	• No ability to widen the flexi-access pot and reduce the level of guarantee if circumstances change • Sustainability of income and tax liabilities are risks that consumers need to manage and organisations need to ensure robust disclosures/process for
INVESTMENTS • **Investment pathways for non-advised** • **Whole pot invested according to consumer objectives**	• Access to investment pathways for non-advised • Ability to grow part of the pension pot	• Money remains invested and this reduces slowly over time with the purchases of guarantee segments • Can offer same/similar investment options to flexi-access drawdown (although potential for more complex investment solutions being needed)	• Consumers will need to manage a pot being used for two different purposes which could be very difficult using investment pathways • More complex and diversified investment strategy may be required

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