PENSIONS POLICY INSTITUTE

PPI

Consumer financial advice and guidance for high risk DC savers

Executive summary

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Executive summary

There has been an increased focus on the role of regulated financial advice, alongside the introduction of free guidance for individuals, in the light of the new pension flexibilities. Despite this, uptake of both guidance and advice remains relatively low and there are concerns, in particular, around those individuals who will rely on their Defined Contribution (DC) pension savings to supplement their state pension, who have low levels of financial education and are unlikely to take regulated financial advice.

Such concerns centre on the risks to the quality of life of these individuals if they prematurely exhaust their pension savings. However, there are also consequences for the economy of the UK if these groups rely on means-tested benefits having spent their pension savings. There are also potential macro-economic consequences where retired individuals have lower incomes through sub-optimal use of their retirement funds. With consumption typically declining with age, it has been noted that low levels of spending by older people could limit economic output, potentially worsening the UK's economic position.[1] Therefore, effective management of retirement savings could be beneficial in the following ways:

- Optimal management of their retirement funds may lead them to having higher incomes in retirement,
- This may also help them to avoid the negative consequences of prematurely exhausting their pension savings.

While it may not be the case for all individuals that an increase in their retirement income leads to increased spending, there is a risk that levels of consumption will decrease for those individuals who spend down their retirement savings prematurely.

In order to consider some of these concerns, LV= commissioned the PPI to research and provide an overview of demand for and the supply of financial advice and guidance, along with some of the options that might bring these in line with each other. This research provides an overview of some of the options with the aim of stimulating discussion around these, rather than providing any quantitative analysis of the likely outcomes of each option. Further investigation would be required to evaluate each option in order to assess the potential outcomes from these.

Regulation shapes the current landscape for supply of UK financial advice

The Retail Distribution Review (RDR), conducted by the re-named Financial Conduct Authority (FCA), introduced at the beginning of 2013, made far-reaching changes to the delivery of financial advice. It may have contributed to the decrease in the number of Independent Financial Advisers (IFAs) and their increased focus, due to commercial considerations, on wealthy individuals. This increasing focus on wealthier individuals occurred at the same time as the appearance of a new group of individuals with relatively modest pots who may

[1] Brancati, et al (2015)

benefit from financial advice around retirement as a consequence of the pension flexibilities. This represents a potential lack of fit between the supply of and demand for financial advice.

A range of guidance and advice services is currently available to UK Defined Contribution (DC) savers

While individuals may choose to access regulated financial advice, a range of free guidance services is also available to individuals. As well as advice from employers, pension providers and government departments, this includes Pension Wise, a potentially valuable government-funded service that was introduced as a result of the introduction of the pension flexibilities from April 2015.

There remains a gap in advice and guidance provision

As the Pension Wise service does not advise individuals on how to use their pension funds, individuals who use the service may still face complex decisions, although they may be better informed about available options. While the Pension Wise service is highly regarded and therefore potentially very valuable the volume of customers is low relative to the population approaching retirement with DC savings. Of those who have withdrawn some money from their DC pensions since April 2015, just over one in five have used Pension Wise.[2] Similarly, take-up of paid-for financial advice remains relatively low.

With the introduction of the new pension flexibilities, decisions about accessing DC pensions have become more complex

In light of this complexity previous PPI research has identified the characteristics of those who are most at risk of making sub-optimal decisions and may need advice or guidance most. This group of high risk individuals may be largely impacted by the financial decisions they make (Box Ex1 and Chart Ex1).

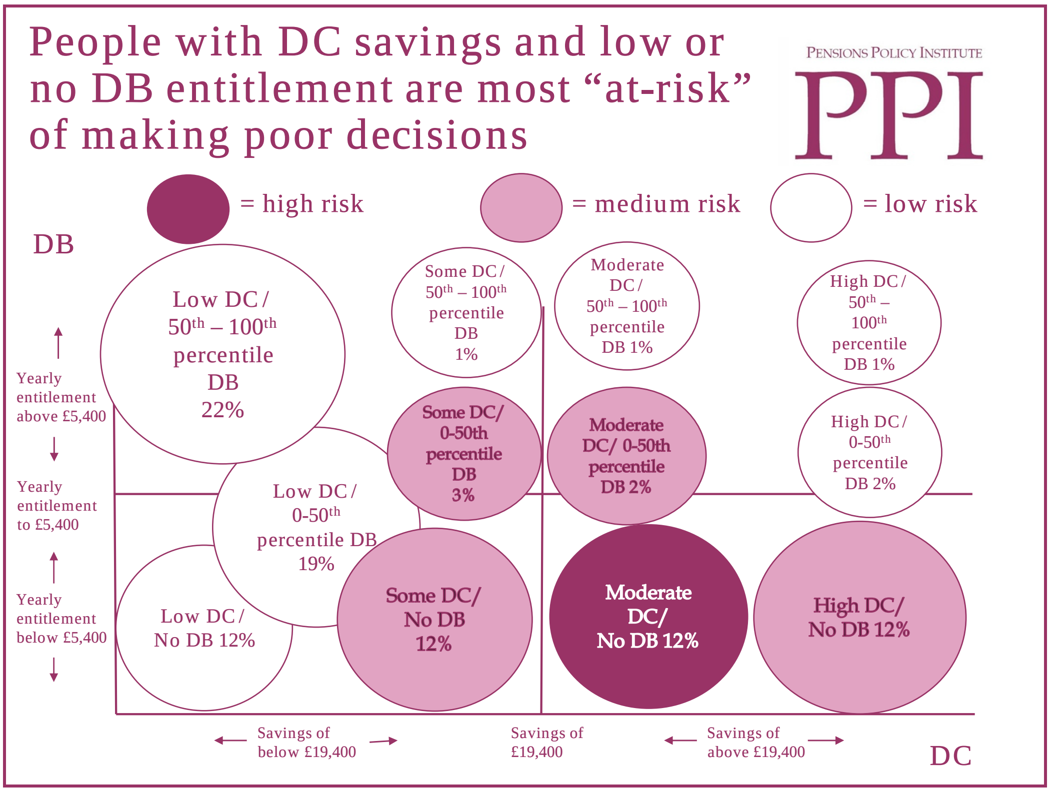
Box Ex1: High risk group[3]

The high risk group includes people with DC savings of £19,400 to £51,300 and no Defined Benefit (DB) entitlement. This constitutes 694,000 people, 12% of people who are aged 50-SPA (State Pension Age) in 2014. This group are at high risk of making sub-optimal decisions at retirement and may therefore benefit from financial advice.

[2] www.bbc.co.uk/news/business-35419330

[3] PPI (2014)

Chart Ex1



The high risk group faces barriers to seeking advice related to awareness, affordability and lack of trust in financial services

Some factors that prevent individuals from accessing advice or guidance include:

- Lack of awareness that advice exists
- Inability to afford advice or unwillingness to pay for advice at its current cost, including a perception of the cost of advice as a loss
- Lack of trust in financial services
- Lack of understanding of the benefits of financial advice
- Feelings of powerlessness or helplessness around issues related to finances
- Absence of an event that might trigger individuals to seek financial advice
- 'Egotistic discounting', overconfidence in one's own decisions

There remains confusion around what constitutes 'advice' and recognition that this may hinder the development of approaches that help individuals to implement the pension flexibilities

Different organisations have been more conservative in interpreting and applying these rules than others. The FCA has looked to clarify this; in particular it has pointed out that, where a decision tree is used, the person asking the questions would need to make any judgment or assessment that results in products being identified as suitable for the customer in order for this to be considered as regulated advice.

While many people are turning to technology to seek financial advice and guidance, there remains a group that online solutions to financial advice fail to reach, who may require other solutions

These people who are offline are more likely to be vulnerable groups such as older and/or disabled people and those from lower socioeconomic backgrounds.[4] The main digital divide lies between those below SPA (79% of households have access to the internet) and those above SPA (37%).

However, there is the potential for online solutions to reach the high risk group as internet access has consistently improved year on year (55% in 2005 to 86% in 2015). It is likely that in the future more people, including those above SPA, will have access to the internet, although there will be some exceptions to this.

Approaches that could address demand for financial guidance and advice include increasing awareness of Pension Wise and the introduction of greater numbers of employer-sponsored financial education programmes

More targeted publicity for Pension Wise may increase awareness of guidance and advice. An increase in the number of employer-sponsored financial education programmes would help consumers to assess the value of financial advice. These could also potentially address issues around trust in financial services and feeling of powerlessness, both barriers to seeking financial advice.

On the supply side, the use of scalable solutions, such as robo-advice and online guidance, is emerging in the UK and may reduce the cost of advice so that it is perceived as affordable

Under the new pension flexibilities, there is a group of individuals, with relatively small pension pots, who may benefit from financial advice at retirement but may not be prepared to pay for it. Scalable solutions with lower fees may be cheaper for these consumers and, with larger numbers using these solutions, may provide a commercial proposition to providers. Compared to the free guidance services, these have the benefit of offering a product recommendation.

Currently, the use of robo-advice and online guidance has focused on helping individuals manage their investments during their lifetime and prepare for retirement. However, approaches are emerging that help individuals to make decisions around how to access their retirement savings. This type of robo-advice and guidance is important because it targets groups of individuals who have not traditionally sought financial advice. However, the use of fully-automated advice may still be subject to the behavioural barriers that cause a reluctance to seek or take advice in the first place. Levels of take-up of these services, as well as outcomes from the use of robo-advice, remain to be seen.

However, any robo-advice solution will need to be sufficiently robust to deal with current market concerns around the risk of mis-advising people, as well as the potential for scamming.

[4] ONS (2015) Internet access

The cost of some types of advice to the individual may be reduced so that it is perceived as affordable by the introduction of a voucher scheme

Her Majesty's Treasury (HMT) recently issued a consultation around public financial guidance that made reference to a possible model of government-backed voucher scheme 'whereby a consumer could be provided with one or multiple vouchers for financial guidance or advice sessions which could be redeemed with a range of accredited partners.'[5]

Potential advantages of a voucher scheme include:

- raising awareness of financial advice
- normalising financial advice
- providing individuals with the right contacts if they require financial advice in excess of the voucher value

There may also be potential consequences for the economy if the provision of vouchers leads to individuals taking advice that enables optimisation of their retirement funds and, in turn, higher long-term income and expenditure and lower levels of reliance on means-tested benefits. Further modelling would be required to investigate this.

However, risks around voucher schemes include increases in fraud, customers incurring unexpected costs (where the value of the advice exceeds the voucher value) and the provision of low quality advice.

The use of default strategies could be an alternate or complementary approach

An alternate or complementary approach would be to increase the use of default strategies in retirement that might be used with or without financial advice. Defaults have been used in the UK during the accumulation phase where automatic enrolment harnesses individuals' inertia with the aim of increasing pension contributions. The effectiveness of defaults depends on whether there is sufficient common ground between groups of DC savers approaching retirement to inform the proactive design of new default strategies, or a limited set of choices, that can support them into retirement even if they fail to engage.

These approaches to advice or guidance are unlikely to provide certainty around outcomes

This lack of certainty contrasts with the period preceding the new pension flexibilities in which annuities provided some level of certainty at a cost to the individual. Regardless of whether individuals use guidance, advice or defaults, a challenge remains around how to communicate this type of uncertainty in a way that enables individuals to make informed choices about their retirement savings

[5] www.gov.uk/government/consultations/consultation-public-financial-guidance