Executive summary

Pension and retirement transitions have become more staged and gradual
Pension provision in the UK has historically been provided through a combination of a Defined Benefit (DB) model, sponsored by employers, and the state pension or state benefits. The DB and state pension models, coupled with a Default Retirement Age have all encouraged people to take their pension at the same time that they retire, as a single "taking a private and/or state pension and leaving work" event, whether this be at Normal Pension Age or at State Pension Age.

Over the past few decades, the Defined Contribution (DC) model has become more popular with employers, creating more variation in the pension and retirement landscape. DC pension savings, generally converted into an annuity, involve more choice by the consumer than DB pensions, as to the structure of the income stream and the age at which to commence.

This change, considered alongside other changes such as rises to State Pension Age, and some Normal Pension Ages (the expected age at which to take a DB pension as income), the removal of the Default Retirement Age (the age at which an employer was legally allowed to terminate employment on the basis of age), increases in longevity, and economic challenges, have all resulted in changes to the way that people approach retirement and pension transitions. What was traditionally a single event (leaving work and taking a pension) has for many people become more staged and gradual as people work longer, and often more flexibly, and as opportunities for taking pensions in stages have become more readily available.

The number of people saving in DC pension schemes is rising
The introduction of auto-enrolment in 2012 also means that many more people are being brought into pension saving, particularly into private sector DC pension schemes, as many private sector DB schemes are closing to new members. Changes announced in Budget 2014 also mean that, from April 2015, people with DC savings will be allowed greater levels of flexibility when they come to access their pension savings after the minimum pension age (currently age 55). There is already evidence that people are interested in the new flexibilities and feel that they need assistance in making decisions about their DC savings in light of the announcement. The number of calls to The Pensions Advisory Service regarding at-retirement decisions increased after the Budget announcement that further flexibilities would be introduced. In the first few weeks after the announcement, the proportion of helpline calls received by TPAS about at-retirement decisions rose from 15% of calls to 45%.

There are a range of options potentially facing people at and during retirement
All of these changes mean that now, and particularly going forward, people contemplating a work or pensions transition can in some cases face an array of options such as when, how and whether to retire; when and how to take state and private pensions; and when and how to access non-pension savings and

assets. Each transition has several options within it and there are myriad ways to combine them. However many work and pension transitions are involuntary, such as those triggered by ill-health or redundancy. Not everyone has a range of assets and savings to depend on in retirement and for many there may be strong defaults dictating how they retire.

The PPI conducted a workshop with experts on the behaviour and psychology of pensions and retirement decisions.[1] The workshop explored the range of options facing people in the lead up to and at retirement, then explored the knowledge and skills that people need in order to make informed decisions about these options. The workshop also explored the knowledge and skills that people need in order to make informed decisions about other major financial decisions from across the life course.

The workshop participants ranked decisions related to pensions and retirement, and other major financial decisions from across the life course by the difficulty of making an *informed financial decision* on each.

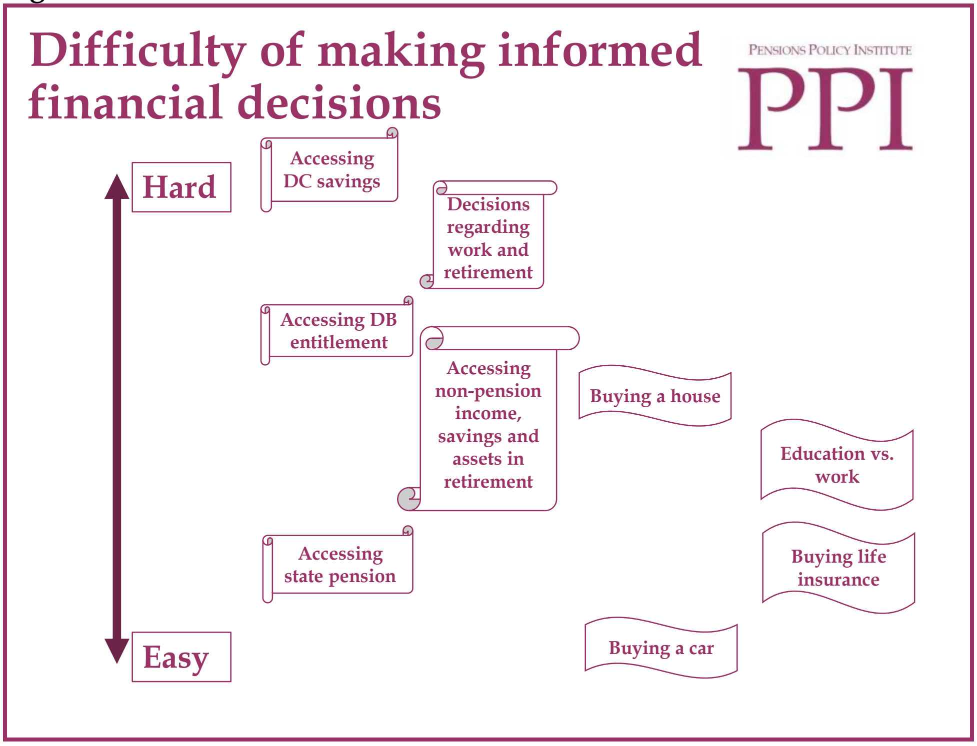
Decisions about accessing DC pensions are considered the most challenging of pension and retirement decisions and other major financial decisions from across the life course

The workshop's considered opinion was that making informed decisions about accessing DC savings was the most difficult of both pensions and retirement and other financial decisions (Figure EX1). The factors considered necessary to make informed decisions about DC savings involve knowledge about the economy and market-risks, numerical skills and knowledge about the potential impact of unknown factors. Making informed decisions regarding work and retirement were ranked as the second most difficult as these all involved a high degree of uncertainty.

Making informed decisions about accessing DB entitlement were considered the third most challenging, just above making informed decisions regarding accessing other income and assets, buying a house or choosing between further education and work. Making an informed decision about accessing state pension entitlement, purchasing life insurance or purchasing a car were ranked the easiest, as the outcomes of these decisions were relatively simple to understand and there are strong defaults attached to some of these options.

[1] The workshop was attended by: Christopher Brooks, Senior Policy Manager (Age UK), Alev Sen, Policy Researcher (CAB), Dr Paul Cox, (CHASM), Alan Higham, Retirement Director, (Fidelity), Janette Weir, Director (Ignition House), Anthony Tomei, Visiting Professor (King's College), Melinda Riley, Head of Policy, (TPAS), Rebecca Fearnley, Chief Adviser, (Which)

Figure EX1[2]



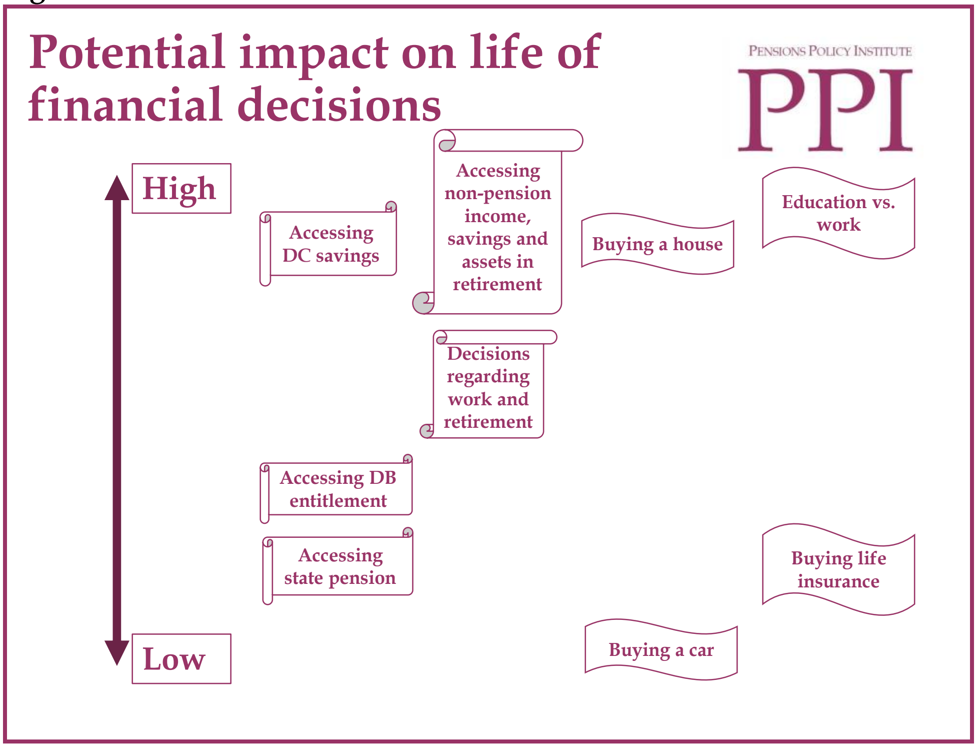
The decisions were re-ranked by the level of impact they might have on people's future financial outcomes.

The level of financial impact that decisions about accessing pension or non-pension savings and assets will have on an individual is dependent foremost on the levels of savings or entitlement that the individual has accrued of a particular type. If the level of savings or entitlement of one type is small, and the individual has substantial levels of savings or entitlement of other types, then the decision may have less of an impact. If the individual has accrued a large level of savings and entitlement of one type, such as DC savings, and has very little other types of savings or entitlements, then the impact of any decision made might be more profound. Those with small levels of savings or entitlement may also experience a relatively greater impact from decisions about access if they have very little other savings, entitlements or assets to fall back on.

The workshops considered opinion was that decisions about accessing DC savings, the most difficult to make an informed decision on, were also near the top of the ranking of financial impact level. Decisions about further education versus work, buying a house and accessing other income and assets in retirement were also ranked as having the highest potential for financial impact during the lifetime (Figure EX2). The areas that were considered most difficult to make an informed decision about and were also likely to have a high financial impact were those about accessing DC savings, and decisions about work and retirement.

[2] Rankings agreed by working group of experts including representatives from: Age UK, CAB, CHASM, Fidelity, Ignition House, King's College, TPAS, Which

Figure EX2[3]



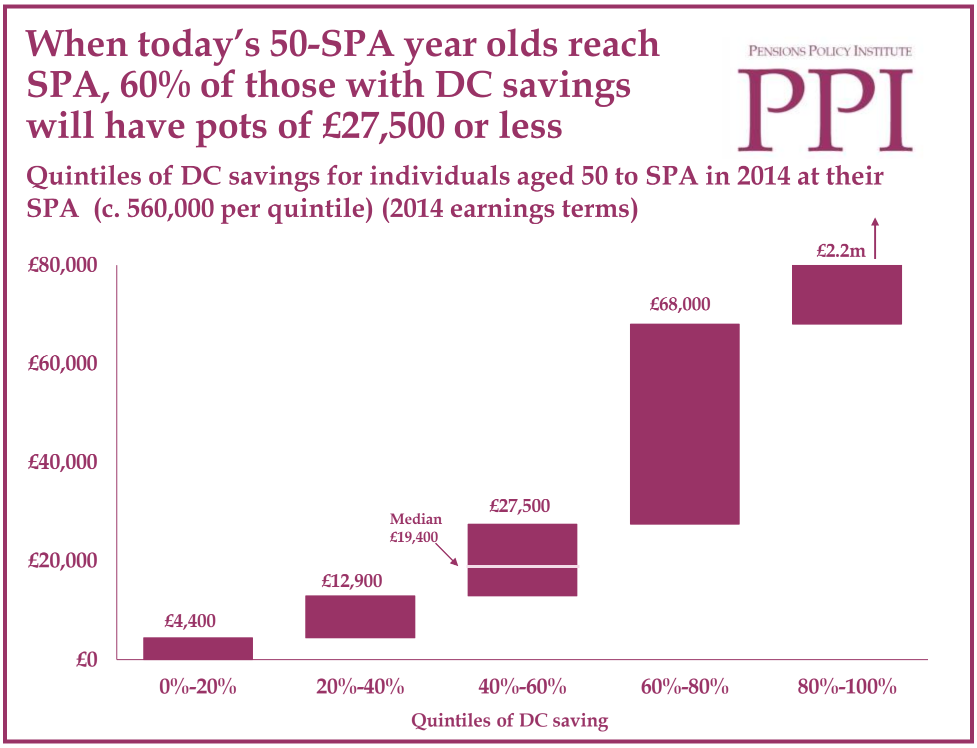
There are varying saving and asset groups within the over 50 population, and these have different characteristics attached to them

This report explores the portfolios of pension saving and entitlement that people will be reaching State Pension Age with today and over the next ten to fifteen years. It defines different segments within this group and looks at which segments are faced with the highest risks and most complex decisions at and during retirement and how these correlate with financial skill and engagement. The segment groups are separated by level (25th percentiles) of DC savings, then further divided by level of DB entitlement (those with less than the 50th percentile of DB entitlement - £5,444 per year - and those with more than the 50th percentile) to create 12 separate segments.

The DC portfolios of groups approaching retirement over the next ten to fifteen years are of special interest, as it is people with this type of savings who will be most impacted by the Budget changes introducing further flexibility of access to DC savings. Simulating ageing for all of today's 50 to SPA year olds with DC savings till they reached their own individual SPA and considering them as one population, then 60% of them are modelled as having pots of £27,500 or less (2014 earnings terms) (Chart EX1).

[3] Rankings agreed by working group of experts including representatives from: Age UK, CAB, CHASM, Fidelity, Ignition House, King's College, TPAS, Which

Chart EX1[4]

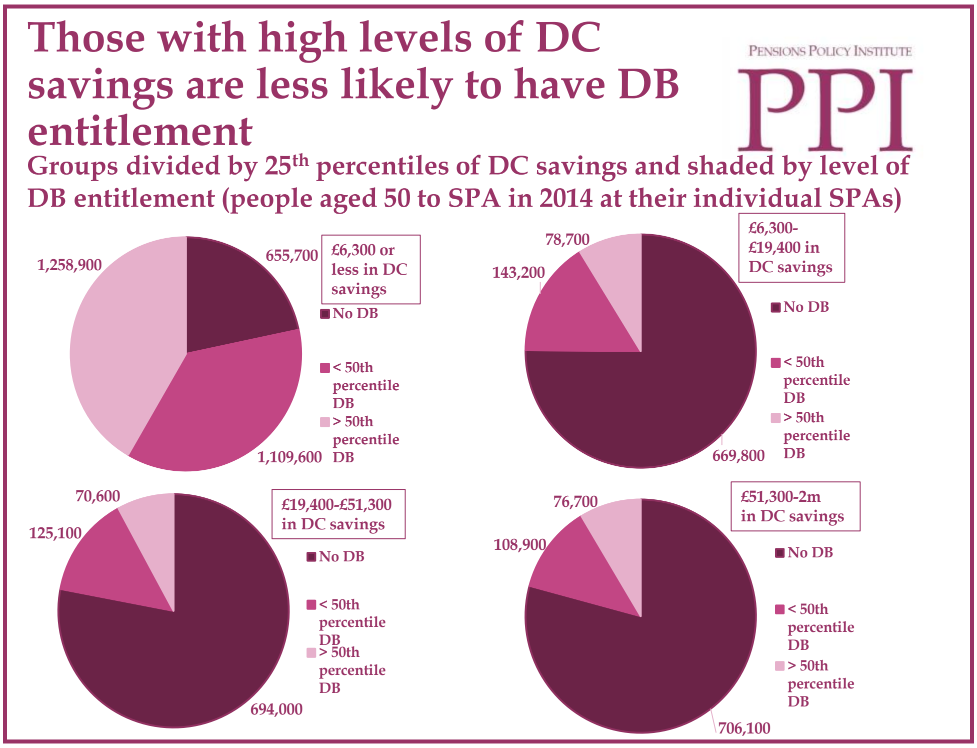


Half of people currently aged between 50 and SPA with pension savings will have £6,300 (2014 earnings terms) or less in DC savings by the time they reach their SPA – including some with no DC savings

Around 5.7 million people currently (2014) aged between 50 and SPA will have some private pension savings or entitlement at their SPA. Around half of these people will have DC pots of £6,300 or less, including those who will have no DC savings. Around three quarters of this group will have DB entitlement. Half of this group will have DC pots of £6,300 or more and around a quarter of these will have DB entitlement (Chart EX2).

[4] PPI Dynamic Model

Chart EX2[5]



The segment groups have been assigned risk labels reflecting indicators such as degree of dependence on DC, whether they had DB entitlement to fall back on, and their likely ability to make "good" DC decisions based on their levels of financial skill and engagement.

Those who are judged to be very dependent on DC savings are determined to have higher levels of risk. Risk level can be mitigated by other factors such as whether people have substantial enough DC savings to afford the risk, whether they were more likely to use independent advice, and whether they were likely to have higher numerical ability, or score well on proxy indicators of financial skill and engagement (Chart EX2, Table EX1).

The highest risk group was those with £19,400 to £51,300 (the 50th to 75th percentiles of DC saving within the sample group) of DC savings and no DB entitlement

The group identified as being exposed to the highest risk was those with £19,400 to £51,300 of DC savings and no DB entitlement. This group constituted 694,000 people, 12% of people aged 50 to SPA in 2014, aged to their individual SPAs. The people in this group are likely to rely mainly on the state pension or state benefits, but have moderate DC savings which could be used to support retirement through a combination of paying off debts, spending on necessary items (such as home repairs) or as a source of retirement income. However, this group scores low on proxy indicators of financial skill and knowledge and are less likely than people in some other groups to use independent advice which

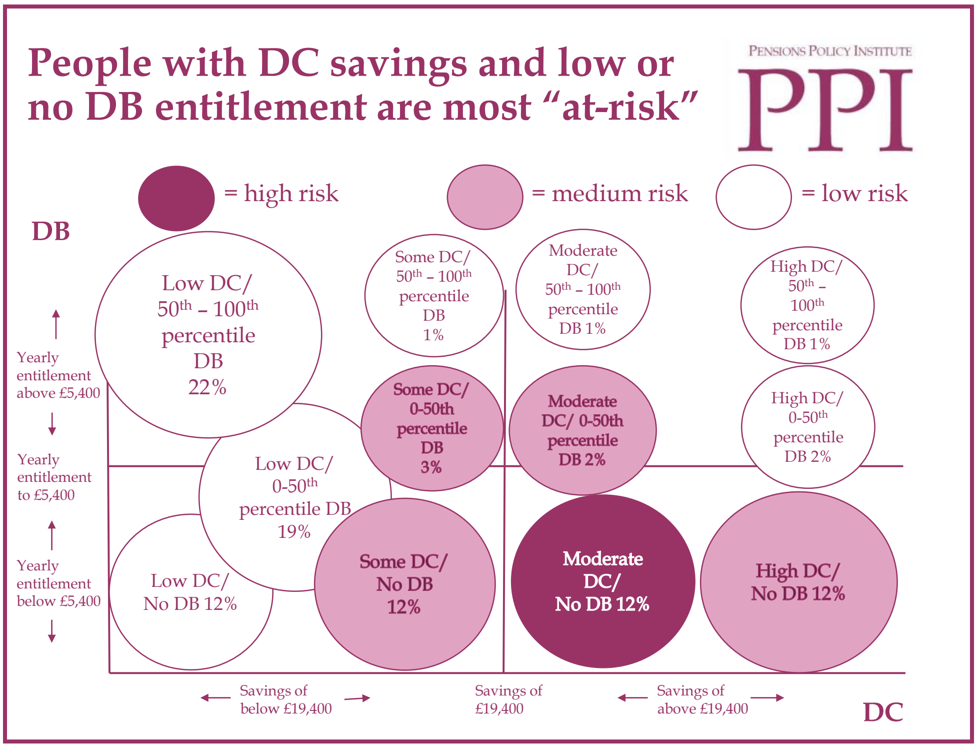
[5] PPI Dynamic Model

might aid in determining the best use for their DC savings. For some people this may be because regulated financial advice appears unaffordable, though many people may be unaware that there is commission attached to the sale of products that are non-advised. If they make a poor decision about their DC savings they have little other income sources than the state or housing assets to fall back on. Prior to the transitional arrangements introduced in 2014, many of the people in this group would have had to purchase a lifetime annuity or invest in Capped Drawdown with their DC savings because they would have been above the trivial commutation limit of £18,000. After April 2015 all of these people will be able to flexibly take their DC pension savings after the minimum pension age and therefore they will face an array of decisions that they would have had to if they were purchasing a lifetime annuity or Capped Drawdown.

Around 29%, or 1.6 million, of people aged 50 to SPA in 2014, aged to their individual SPAs, are classified as having a medium risk level, because they will be dependent to some degree on the income from their DC savings in retirement, have little other savings and assets to fall back on and have low levels of financial skill and engagement. They were not classified as high risk either because they are relatively less dependent on their DC savings (due to other savings or entitlement or because they have low levels of DC savings) or because they have enough DC savings to be reasonably expected to use advice, or not suffer the same proportionate loss from making poor decisions.

Those labelled as "low-risk," because of high levels of DB entitlement, constitute around 25% of the population analysed. The majority of these people have low levels of DC savings and either have high levels of DB savings, or will be dependent mainly on the state pension and, possibly, state benefits (Chart EX3).

Chart EX3[6]



This report looks at different indicators and how they correlate with pension and non-pension savings portfolios

It is useful to explore how different indicators correlate with pension and non-pension saving portfolios because they can provide information about the likely needs and characteristics of different groups. For example, profession based socio-economic class can give indications about education, income level and the likelihood of people being able to work longer or more flexibly. For example, those in lower profession based socio-economic classes are less likely to have flexible working options available to them and are more likely to have to leave work for involuntary reasons such as health problems.

The level of non-pension savings and assets held by people gives an indication of how dependent they might be on one source of pension savings or on the state. Proxy indicators of financial skill and engagement can allow judgements to be made regarding people's likely ability to make complex decisions about accessing pension savings without assistance. The following table sets out the segment groups and indicates whether they scored high, medium or low in each of these indicators.

[6] PPI Dynamic Model

Table EX1[7]

Group average scores on different indicators – colour-coded by risk level High = ✓ Medium = ~ Low = X *DC – total savings* *DB – yearly entitlement in 2014 earnings terms*	Socio-economic class	Non-pension savings and assets	Proxy indicators of financial skills and engagement
Low DC/No DB *(£6,300 or less (DC), No (DB))*	X	X	X
Low DC/0-50th percentile DB *(£6,300 or less (DC), £5,400pa or less (DB))*	X	~	X
Low DC/50th-100th percentile DB *(£6,300 or less (DC), £5,400-£300,400pa (DB))*	~	~	~
Some DC/No DB *(£6,300-£19,400 (DC), No DB)*	X	X	X
Some DC/0-50th percentile DB *(£6,300-£19,400 (DC), £5,400pa or less (DB))*	~	~	~
Some DC/50th-100th percentile DB *(£6,300-£19,400 (DC), £5,400-£300,400pa (DB))*	✓	✓	~
Moderate DC/No DB *(£19,400-£51,300 (DC), No DB)*	~	~	X
Moderate DC/0-50th percentile DB *(£19,400-£51,300 (DC), £5,400pa or less (DB))*	~	~	~
Moderate DC/50th-100th percentile DB *(£19,400-£51,300 (DC), £5,400-£300,400pa (DB))*	✓	✓	✓
High DC/No DB *(£51,300- 2m (DC), No DB)*	✓	~	~
High DC/0-50th percentile DB *(£51,300-2m (DC), £5,400pa or less (DB))*	✓	✓	✓
High DC/50th-100th percentile DB *(£51,300-2m (DC), £5,400-£300,400pa (DB))*	✓	✓	✓

[7] PPI Dynamic Model

After April 2015, decisions about accessing DC pension savings will become more complex

In order to make an informed decision about accessing DC savings and structuring income in retirement people need to be able to understand economic factors such as inflation, market-based risks and longevity risk. Therefore, people may struggle more with complex decisions regarding using DC savings to support themselves in retirement than those with DB savings who can make an informed decision based on a more limited understanding (as scheme rules generally protect members against inflation, market based risks and longevity risk).

Decisions about accessing DC savings will become more complex after April 2015 when people will no longer be required to use a recognised retirement income product. Retirement income products such as annuities and income drawdown previously had some safeguards against market-based and longevity risks built into them, and many, such as lifetime annuities, will continue to do so after April 2015. However, people who choose not to purchase a retirement income product which protects against risk with some or all of their DC saving after April 2015 will have to make decisions about how to protect themselves against risks, many of which are not predictable (such as inflation risk and longevity risk). The 56% reduction in annuity purchases observed in Q3 of 2014 (in comparison to Q3 of 2013) indicates that far fewer annuities will be purchased by people with DC savings in future, and that their funds may therefore be exposed to these greater levels of risk.

Levels of numeracy in particular have been found to have correlations with ability to understand pension arrangements. However, having DC savings and no DB entitlement is associated with lower levels of numeracy. People with DC savings and no DB entitlement will also be more dependent on using their DC savings to provide themselves with an income in retirement than those who have some DB entitlement to fall back on but may also have more difficulty making a fully informed decision about accessing their DC savings.

Though many people with DC savings (between 70%-80%) reported receiving information from their scheme or provider, people report finding scheme communications confusing and difficult to understand. Natural tendencies towards inertia can be further exacerbated by complexity, uncertainty and a lack of understanding.[8] Therefore, scheme communications, without significant redesign, are unlikely to fill the gap in knowledge or provide the support that people with DC savings might need to make complex decisions, particularly once people over the minimum pension age are allowed complete flexibility to access DC pension savings.

Decisions about accessing DC savings are likely to be very difficult for people to make without assistance. However, regulated financial advice has an upfront cost attached to it which might make it appear inaccessible to people with small amounts of DC savings. Regulated advice may not be unaffordable in practice

[8] DWP (2012a) p. 23

in comparison to the sale of non-advised products which often have a commission attached. But use of regulated financial advice was very low on average among all the segments, ranging between 4%-9% engaged from each segment excepting for those with the highest levels of DC saving and no DB savings, 14% of whom had used an IFA.

The Guidance Guarantee will need to be able to fill the gaps in advice and information required by people with DC pension savings

It will, therefore, be imperative that the new Guaranteed Guidance service is particularly able to engage with people with DC savings and no or low levels of DB entitlement who might be in danger of making decisions which are detrimental to their outcomes in retirement due to low levels of numeracy or cognitive or behavioural barriers.

During a pensions guidance pilot on at-retirement decisions, only 2.5% of customers were reported to have taken up the offered guidance.[9] This suggests that, as with the accumulation stage, there may be a substantial group of individuals who do not wish to engage in decision-making around their retirement provision. Recent PPI research analysing findings from a consumer survey found that individuals' intentions around their DC pensions are characterised by a high degree of uncertainty around both when they might retire and how they will access their pension savings. Even 12 months ahead of their expected retirement dates, only around 50% of DC savers say they know what they expect to do with their pension pot at retirement. So, even if engagement can be achieved, it is unlikely that savers will have clear or definitive views on their expectations and preferences in retirement. It is more likely that gradually raising their awareness ahead of retirement around the choices and trade-offs they will face will help them to become comfortable with any default options they are offered by their schemes or providers, or will prompt them into exploring where they can find further help, beyond any initial guidance service.

For those who do engage with the guidance, they may need ongoing support, not just around decisions at retirement, but decisions later on in retirement as income needs or sources might change for people several times during retirement because of changes of health, household makeup, and increases or decreases in available income. It is not yet clear whether people will be only allowed to use the Guidance service once, in the lead up to retirement, or will be allowed to have multiple sessions. It might be worth investigating whether people would benefit from the offer of several targeted guidance sessions throughout retirement. It may also be worth investigating whether the guidance should be offered to people of working–age who are still making decisions about saving in a pension.

It should also be taken into account that people who do not act on advice or guidance immediately after receiving it may be less likely to make a decision or to make a decision with positive outcomes. Those who are more impulsive or

[9] www.moneymarketing.co.uk/2015140.article?cmpid=pmalert_590745

more prone to inertia are the least likely to act on advice or information right away. These tendencies could be considered in the design of advice. There are ways of helping people to take action, for example giving them easy, practical steps to follow, or by including the action as part of the advice or guidance session. However it may be more difficult to give people these options through guidance than through regulated advice.

Those designing the delivery of guidance and communications with eligible customers may want to look at focussing on how to engage with people who have DC savings. If there are behavioural barriers, such as a lack of trust, the communications might want to look at ways of addressing these. Research on people's engagement styles indicate that the framing of messages impacts people's responses; people engage more readily when an option is framed as a "gain" rather than a "loss".[10] People also find making decisions with short-term, tangible consequences easier.[11] Guidance communications could explore ways of incorporating positive messages and perhaps framing potential outcomes as more "tangible" in order to encourage engagement.

Delivery partners must be aware that when customers do engage, they are likely to have varying levels of numeracy and therefore potentially varied abilities to understand and engage with decision-making or to understand the implications of different options. Delivery partners should explore ways of ensuring that those with lower levels of numeracy are provided with information and guidance that they can understand and use to make informed decisions about using DC savings to provide an income in retirement.

Summary of conclusions

Decisions about accessing DC pensions are difficult for people to make as they often require understanding of complex and uncertain economic and market concepts such as inflation, investment risk and longevity risk. Changes announced in Budget 2014 mean that, from April 2015, many people with Defined Contribution savings will be allowed far greater levels of flexibility when they come to access their pension savings. This will further complicate the decisions that DC savers must make as it will increase the number of available options, push the burden of managing risk further onto pension savers, and, in some cases, extend the need for ongoing decision making into retirement.

The people reaching SPA over the next ten to fifteen years vary considerably in their pension and non-pension savings and asset portfolios. Within this population, there are segments who will require greater support than others as a result of reaching retirement more reliant on their DC savings to secure an adequate income, with riskier portfolios and potentially lower levels of ability to make financial decisions. The challenges for these segments will be compounded over the next few years as the industry is still responding to the reforms and adjusting to a new type of pension saver who will be allowed to access their savings more flexibly. The defaults in place for these groups may

[10] DWP (2012a) p. 30-31
[11] DWP (2012b) p. 35 Figure 4.2

either be actively developed in response to the reforms (for example, new drawdown strategies offered directly by a pension scheme or provider) or may be the "path of least resistance options" made available to them (for example, taking the DC pension as cash, or buying an annuity from their current provider). At this early stage it is unclear which options will be most popular.

PPI segmentation based on key characteristics of people currently aged 50-SPA in England indicate that around 12% of the population analysed (694,000 people) will be at "high-risk" of making poor decisions when they reach SPA if they are not offered support through either guidance and advice or suitable defaults. These are groups with between £19,400 and £51,300 in DC savings and little or no additional DB pension to fall back on). A further 29% (or 1.6 million) people aged 50-SPA in 2014 will be at "medium risk" of making poor decisions. These are groups with anywhere from £6,300 to above £51,300 in DC savings and little or no additional DB. This means that around 4 in 10 retirees will need significant support over the next ten to fifteen years because they will be dependent to a significant degree on the income from their DC savings in retirement to supplement their state pension, have little other savings and assets to fall back on, have low levels of financial skill and engagement, and are less likely to already use a financial adviser or be actively targeted by financial advisers in the current market given the size of their pension pots.

There is a particular correlation between having low levels of numeracy and low or no DB savings to supplement their DC savings. Those with low levels of numeracy will find decisions about accessing pension savings particularly challenging but they are also unable to fall back on a secure source of private pension income in the form of an indexed DB pension.

The Guidance Guarantee, which will offer the provision of free impartial guidance to those reaching retirement with DC savings will be operational from April 2015, however there are significant concerns regarding what the take-up of the guidance may be, whether the guidance will be able to meet the level of need and the complexity of the different individual and household circumstances, and the likelihood that individuals will follow up on the guidance they receive with timely and appropriate actions. There are intrinsic issues with engaging with people around pension decision-making that are impacted both by their own high levels of uncertainty around their retirement planning and by behavioural barriers which can lead to inertia and a reluctance to actively engage and take decisions. There were already concerns in place about the availability and quality of guidance and support offered to pension savers prior to Budget 2014 and the announcement of the new flexibilities. It is clear that a large number of people will require even more support and assistance once these new flexibilities are in place.

This research has identified around 40%, 2.3 million, people approaching retirement in England with private pension savings over the next ten to fifteen years who will be most in need of assistance and for whom access to these services will be particularly critical if they are to make the most of their available DC savings to support their retirements.

The number of people retiring with DC pots is expected to grow as more people are brought into pension saving through auto-enrolment, but average pot sizes are likely to remain relatively low over the next few years, with the median DC pot size, for those age 50 to SPA, in 2015 at £13,800 and growing to £23,800 by 2024. It will be critical that the people reaching retirement with DC savings over the next few years are given support. Independent and trusted guidance and advice services, beyond the Guidance Guarantee, will need to be made available to people in these medium to high risk groups. The people in these groups will need special targeted support to engage with and act on advice and guidance or they will be at risk of accepting defaults or making decisions that could adversely impact their retirement incomes.