For pension policymakers and professional organisations only

Collective DC decumulation – is there demand?

AON

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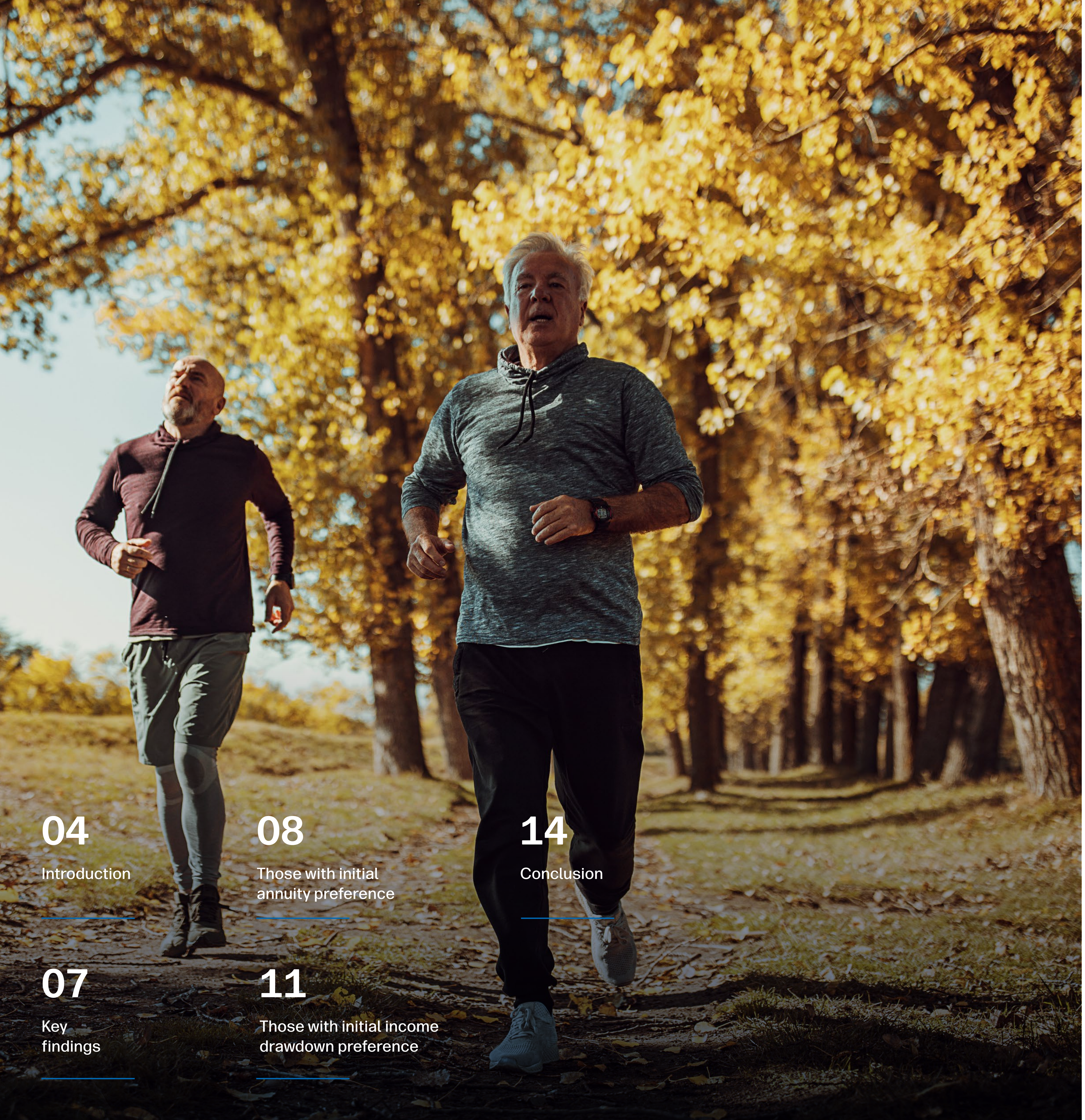


Foreword

Aegon and Aon are delighted to share our consumer research which focuses on the characteristics of post-retirement solutions that matter to individuals. A key question we wanted to answer was the extent to which a decumulation-only Collective Defined Contribution pension (which we refer to here as a 'CDC pension') may form a valued addition to the existing choices available to people on retirement from a defined contribution (DC) pension plan. Our findings show that with the assumptions we make, there could be significant demand for CDC pensions as an alternative to drawdown and annuities.

The research was carried out before the Department for Work & Pensions (DWP) consultation **Extending Opportunities for Collective Defined Contribution Pension Schemes – January 2023** but is very relevant to the proposals set out there. We see it as potentially informing next steps for the development of CDC and with this in mind we wanted to make our key findings widely available.

Steven Cameron, Pensions Director at Aegon:

'With the ever-increased importance of DC pensions, it's necessary to explore the options individuals have for turning their accumulated pot into a retirement income. We found the research fascinating and along with Aon wanted to share the findings more widely.'

Matthew Arends, Head of UK Retirement Policy at Aon:

'CDC has the potential to deliver better outcomes to millions of individuals in the UK, so we were glad to work with Aegon on this important piece of research. We welcome the opportunity to inform the development of a successful CDC alternative alongside current retirement options.'

Introduction

The DC market has been through significant change over the last decade. However, we believe there is room for further innovation in the post-retirement market to help people achieve the level of retirement security and flexibility that suits their individual desires and needs.

The UK market has currently settled on two options for providing long-term income from a DC arrangement – annuity or drawdown income. In reality, we know that until recently, annuities have not been popular, with just 10% of retirees choosing this option over the year to April 2022, a proportion that is likely to have been influenced by the financial backdrop of what were then low interest rates.[1] The most popular option at retirement (if we exclude small pots being taken as a cash sum) is income drawdown despite the risks involved (notably investment and longevity) and the onus on the individual to make decisions throughout their retirement.

The macro-economic backdrop of recent years has also not been conducive to the development and provision of innovative products. That includes those which provide a reasonable level of income certainty, with the possibility of upside in favourable investment markets. This is because the cost of providing a 'guaranteed' base income certainty has been relatively expensive. While potentially popular in concept, they have not been recommended by financial advisers and/or bought by individuals in large numbers – all of which has made them commercially unviable.

We are now seeing a new option emerge by way of decumulation-only CDC, which the DWP is exploring. A key challenge will be for legislation to balance the need to protect savers, while enabling the effective operation of CDC by providers on commercial terms.

While there is a way to go yet, CDC pensions have the potential to help pension savers meet the goal of efficiently achieving a lifetime income from their DC savings, without having to make complex decisions in retirement. By operating on a pooled basis, the time horizon of a typical CDC fund will be longer than the lifespan of an individual retiree. This, coupled with the absence of a 'guarantee' or Solvency II reserving requirements, allows for a less conservative investment strategy. This means that CDC pensions are expected to provide higher initial income (on average) in retirement than from annuity purchase, while still providing the certainty of an income continuing for life, which drawdown cannot give.

In this report, we focus on the perceived demand from individuals, based on our survey. We hope that our research will both help inform Government and help the wider market to explore the viability of decumulation-only CDC pensions.

Methodology

We surveyed 1,150 respondents in June and July 2022 in an online survey conducted within Aegon's Feedback Community. 80% of those surveyed are Aegon customers and compared to the general population, the Feedback Community included a higher proportion of males (62%) and over 55s (also 62%).

Initially, participants were required to choose a preference between annuity and income drawdown. They were then split into two groups and asked to make carefully-constructed trade-offs of features of:

- CDC pension versus income drawdown or
- CDC pension versus annuity

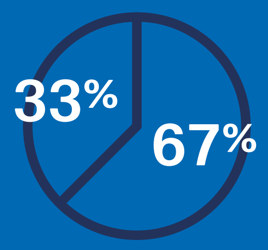
Throughout the research, we avoided using the labels 'annuity', 'income drawdown' and 'CDC' but instead described various features.

The trade-offs an individual was presented with depended on their initial preference for either annuity or income drawdown.

We felt a trade-offs methodology was a better way to assess appetite for different options because it put the participant into a more realistic frame-of-mind compared to asking standard single and multiple-choice questions, which do not provide the reference points that are necessary when expressing preferences.

[1] FCA Retirement income market data 2021/22 – 6/10/22

Key findings

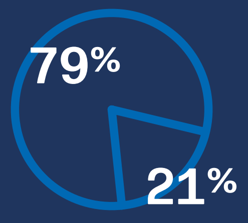


Before viewing information on the relative features of a CDC pension, **33% of participants** preferred the option with features of an annuity, compared to **67%** preferring income drawdown features.

Those most likely to choose an annuity were those of lower-than-average wealth and therefore with a higher degree of dependency on State pension (42%).

Amongst those whose **initial preference was the annuity option**, after viewing the full trade-off series, 49% **now preferred the CDC pension** while 51% still preferred an annuity.

Among those aged 55 and over (where self-reported understanding of the trade-offs was higher), a slightly higher share retained preference for an annuity (56%).



Among those whose **initial preference was income drawdown**, after viewing the full trade-off series, 79% still preferred income drawdown while 21% now preferred the CDC pension. There were no significant differences between under and over 55s.

Overall, CDC pensions were less likely to be chosen by those with higher than-average levels of wealth.

In the main, **those who preferred annuities** over CDC pensions explained their choice as being due to the **lower risk** provided by an annuity.

Those who preferred income drawdown over CDC in the main, explained that this was due to the ability to '**provide for a partner or enable my family to inherit** my savings when I die'.

Overall, 30% or almost one in three of the overall sample ended up after the trade offs with a preference for CDC pension.

Those with initial annuity preference

Participants who expressed an initial preference for an annuity were invited in five separate exercises to trade off features of an annuity against features of a CDC pension. The labels 'annuity' and 'CDC' were not mentioned. Instead, they were neutrally labelled 'Option A' and 'Option B' to allow a focus on features only. We varied the order of CDC and annuity features so that one option was not always featured first.

We made an assumption that CDC pension would pay a higher income than an annuity.[2] The annuity income level was based on a purchase price of £200,000 which we felt was reasonable for the potential target market. We used a single life annuity rate (although in practice we would anticipate individuals being offered a choice of single or joint) with inflation increases. Using competitive rates from the MoneyHelper annuity website in April 2022 for a 65-year-old in good health, we arrived at an annuity income of £480 per month. We assumed a CDC pension would pay out £666 a month. This was derived from a decision to not differentiate between CDC pension income and drawdown income and using the assumption that 4% withdrawals might be sustainable.

We would stress that these were designed to be illustrative and may not represent actual levels in future. Clearly, the actual income levels achievable from CDC pension and from drawdown depend on the asset performance achieved and, in the case of drawdown, the individual's actual lifespan.

The key elements of trade-off we explored are summarised in the following table. Option A is CDC pension and Option B is annuity.

[2] Although CDC pension incomes would generally be higher than annuity incomes due to investing in more return seeking assets, this will not always be the case, for example, in the event that markets significantly underperform.

	Option A	Option B
Income per month	£666 per month	£480 per month
When I die, will there be any payment(s) to go to someone of my choosing?	No	No
What choices do I have around income?	You'll not have any choice – you'll be explained what's intented throughout your future life (and of a partner if you choose) and it may vary up or down based on market performance	You'll decide what 'form' of income you want at outset – level or increasing perhaps with inflation, and whether you want it to continue on your death to a partner. But once you've purchased, there's no flexibility to change thereafter
What's the risk this might go down? Might it go up?	It could be a little more or less than that if markets rose / fell. There are however safeguards in place that ensure you'd get an income for life	There's no risk. This income is guaranteed. It won't go down but it will go up each year if you select an increasing or inflation protected variant
Can I choose if I want inflation protection?	You will get inflation protection automatically	You can choose to have it or not. If you choose this, your starting income will be lower than if you pick a level variant
Am I responsible for investment decisions?	No – you have no choice – a professional will do this	No – there are not investment decisions
Could I gain / lose based on how investment markets preform?	Yes – everyone who buys this product will share in rises and falls in investments. The aim is to avoid any pronounced changes year on year	No

Once participants viewed five individual trade-offs, a final trade-off with all details was shown as above. On that final trade-off, 51% of these people still preferred an annuity whilst 49% now preferred a CDC pension. As 33% of individuals initially chose annuity over drawdown, this 51% represents 16.8% of the overall sample or 1 in 6.

Those most likely to prefer the CDC pension type over annuity are those who typically possess below-average wealth or higher state-dependency (55%, compared to the average of 50%).

Those who were older than 55 (and who had a higher self-reported understanding of the options) were still more likely to prefer annuities (56%).

Those whose preference remained annuity selected the following top three reasons:

- The low risk involved **(72%)**
- The pension will be paid for the rest of my life **(65%)**
- The ability to provide for a partner or enable my family to inherit my savings when I die **(39%)** (We used this factor for both annuity and income drawdown – clearly for annuities, providing for a partner is the more technically accurate statement.)

Those who chose a CDC pension selected the following top three reasons:

- The (higher) potential income I could receive per month **(59%)**
- The pension will be paid for the rest of my life **(56%)**
- The potential for my income to go up if investments do well **(52%)**

The results demonstrate the risk/reward trade-off between the additional level of income offered by CDC pension over annuity and the potential variation in income.

Approximately 80% of respondents felt they understood the features of their preferred option.

Those with initial income drawdown preference

Participants who expressed an initial preference for the features of income drawdown were asked to trade off elements of income drawdown versus the CDC pension.

We made a number of assumptions which may have influenced the choices.

We assumed income levels from CDC and income drawdown would be identical. Some argue that CDC should be able to deliver a higher income because of investing longer term but we decided not to introduce that variability at this stage, meaning that the key differences between the two options presented were longevity protection, inheritance, investment choice and income flexibility.

The key differences we drew out are summarised below. Option A is CDC pension and Option B is drawdown.

	Option A	Option B
Income per month	£666 per month	£666 per month
When I die, will there be any payment(s) to go to someone of my choosing?	No	Yes, your remaining pension pot can be distributed to your loved ones
What choices do I have around income?	You'll not have any choice – you'll be explained what's intented throughout your future life (and of a partner if you choose) and it may vary up or down based on market performance	You decide how much to take initially and you can vary it up or down whenever you want, but if you take too much, you could run out
What's the risk this might go down? Might it go up?	It could be a little more or less than that if markets rose / fell. There are however safeguards in place that ensure you'd get an income for life	You can choose how much you take each year. But if you want to have an income for life, you may need to reduce it if markets don't do well, but you could also be able to sustain more if markets do well
Can I choose if I want inflation protection?	You will get inflation protection automatically	You can plan to start lower and gradually take more as inflation affects you
Am I responsible for investment decisions?	No – you have no choice – a professional will do this	Yes, and you have a wide choice
Could I gain / lose based on how investment markets preform?	Yes – everyone who buys this product will share in rises and falls in investments. The aim is to avoid any pronounced changes year on year	Yes – you are directly affected based on which investments you chose

When viewing the final trade-off with all details included, 79% of these people still preferred income drawdown while 21% now preferred the CDC pension.

Those most likely to prefer the CDC pension over income drawdown were groups with below-average wealth and a higher likelihood of state dependency (28%, compared to the average of 21%).

Among participants who expressed an initial preference for income drawdown, 21% opted for a CDC pension in our trade-off series. While this is a relatively low percentage, it is a proportion of the 67% of members preferring drawdown over annuity at outset – so represents 14% or 1 in 7 of the overall sample. This is close to the 16.8% of the overall sample who switched from an initial annuity preference to CDC pension.

Those who continued to prefer drawdown selected the following top three reasons:

- The ability to provide for a partner or to enable my family to inherit my savings when I die (70%)
- How flexibly I can access my savings including how much I take each year (69%)
- The opportunity for my income to go up if investments do well (37%)

Those who preferred CDC pension selected the following top three reasons:

- The pension will be paid for the rest of my life (66%)
- The low risk involved (45%)
- The ability to provide for a partner or to enable my family to inherit my savings when I die (44%) (Here, we assumed the CDC pension could provide the option for continuation to a partner or beneficiary)

85% of respondents felt they understood the features of their preferred option.

Conclusions

This research shows that there could be considerable demand for decumulation-only CDC alongside annuity and income drawdown. From the overall sample, 30% or almost 1 in 3 ultimately ended up preferring a CDC pension.

A lower proportion of people who initially selected drawdown, compared to initially selecting annuity, ultimately switched their preference to CDC pension. However, because more people initially selected drawdown over annuity, the numbers moving from annuity to CDC pension and the numbers moving from drawdown to CDC pension are quite similar.

It would appear individuals identified and understood the risk/reward trade-off when choosing between the various options. With almost one in three selecting CDC, this suggests a good degree of comfort with the concept even if purchasing 'direct' without an adviser.

The research assumed a binary trade-off between annuity or income drawdown and CDC pension. Individuals could potentially take a mixture of more than one at retirement, but this was not tested.

This research shows some evidence of greater attraction to CDC pensions for the less wealthy. We believe this is an area worthy of further research.

The results will, to a degree, be influenced by the assumptions made, including the likely starting incomes of the three options. Annuity rates, for example, have risen significantly since the research assumptions were set.

There will be other refinements as the policy development on decumulation-only CDC evolves and details are finalised – for example, medical underwriting.

Our research looked solely at the demand for CDC, not the appetite of potential providers to deliver CDC. Further research into both the demand and supply aspects will be needed.

But our key conclusion is that there could be significant demand for CDC pensions.

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