Are centralised retirement propositions the retirement planning Yin for the central investment proposition Yang or just another 3 letter acronym?

This paper was produced and authored by Tony Slimmings, a chartered financial planner and founding director of the We Complement. It is meant for professional advisers not the general public.

This document is meant as a guide to producing a robust CRP, it is not a full guide to pension income drawdown, Indeed we have reviewed many long (70+ page) documents as part of our research and see little point in repeating each in full.

We are seeing an increase in the number of advisers and providers who believe that a centralised retirement proposition (CRP) is more than just the latest retirement buzz word. Despite this there still appears to be no universal definition of what a CRP actually is. In our view, however, they are not just simply withdrawal-based CIPs.

'Freedoms' That have Created 'Confusions'

Pension freedoms have altered the landscape in retirement planning. Decumulation, the made-up word created to describe the investment process in retirement has brought with it the 'new' world of flexible access. Consumers are now 'free' to empty their pension pots at age 55 and fund the 'holiday of a lifetime' (well, pre Covid 19 anyway). For those clients and consumers not fortunate to have very large pension pots or to be provided with a guaranteed retirement income large enough to fund their retirement income needs, final salaries etc. there used to be one real choice, buy an annuity and adjust. The majority of retirees to date have never had to consider the long retirement journey ahead and are now making 'plans' and taking decisions through the lens of a healthy 50/60 year old.

As highlighted in the excellent book 'Beyond The 4% Rule: The science of retirement portfolios that last a lifetime' by Abraham Okusanya, we need to think differently about income drawdown sustainability and consider different income solutions for different client's income needs. This change in mindset will not be easy and the requirement for a new solution to a new problem has not been universally embraced by the advisory community.

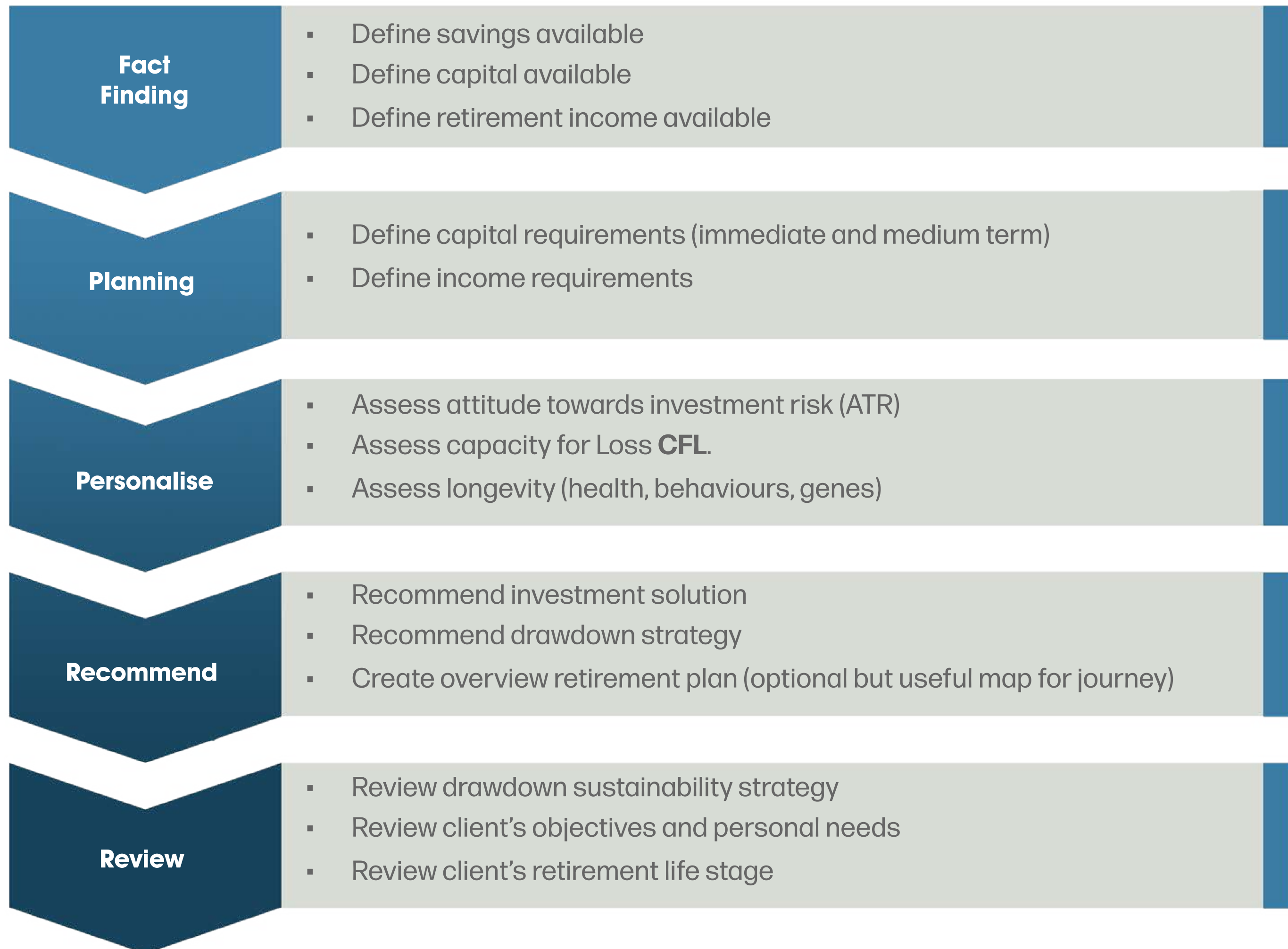
Any new approach needs to address the significantly different risks facing clients in retirement. Sequence of returns risk needs to be considered to avoid pound-cost ravaging; inflation risk needs to be assessed to maintain purchasing power; and longevity risk countered – to simply ensure clients do not live longer than their money!

"Deciding how to use pension savings is one of the most important financial decisions people will make in their lives...consumers need to manage longevity and investment risks by choosing appropriate investment and withdrawal strategies."

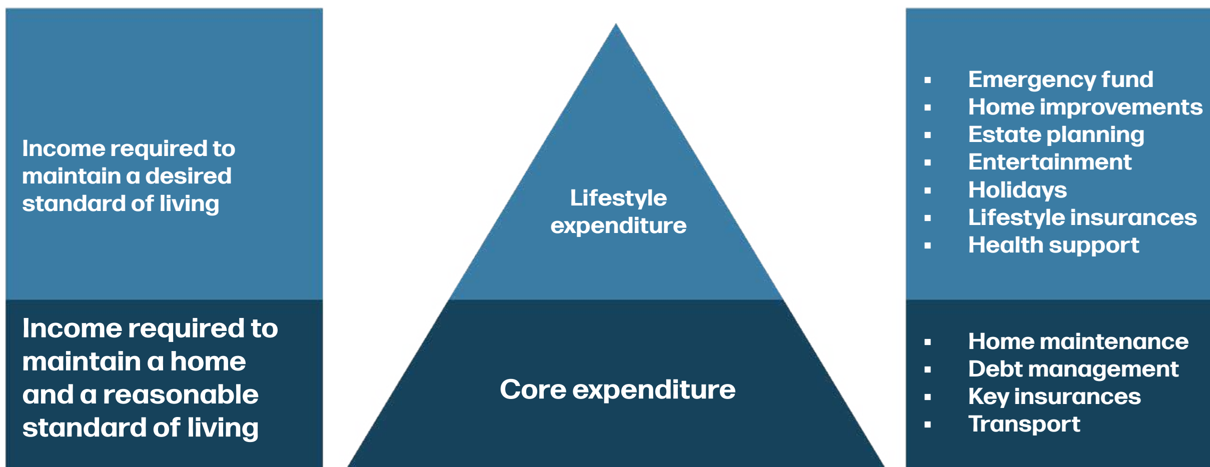
Retirement Outcomes Review Interim Report MS16/1.2, FCA, July 2017

Considering the 'Decumulation' process

The 'easy' part of a decumulation (income drawdown) process is that it is a straightforward continuous process:



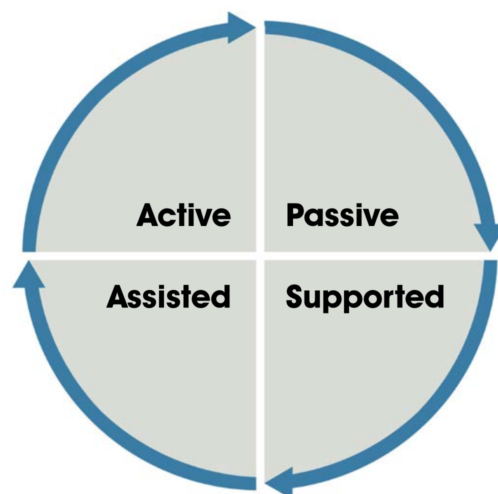
Once existing assets, available income and short to medium term capital requirements have been confirmed it really is important to fully understand and document the client's income need. Ask your client to list their expenditure and then consider categorising it as indicated in the following chart:



Source: Defaqto

Income for the retirement journey stages

To complicate matters further we need to break this down into how to manage the expenditure needs through the four stages of retirement:



Active: Where health and wealth allow an active lifestyle – holidays etc.

Passive: When spending starts to decrease as reducing health limits mobility.

Assisted: When spending could begin to increase again to accommodate lifestyle – move to bungalow etc.

Supported: When ongoing and fulltime healthcare could be required.

Additionally, client's individual needs and strategies are a key consideration here as retirement clients are likely to have very different objectives with very different needs. For example, there are those clients for whom income in retirement is an additional luxury and there are those who rely on income and are more concerned about sustainability, to highlight just a few.

It is time get to get personal
As well as assessing ATR, which is based on emotive client responses and generally the FCA believe advisers do well, reviewing capacity for loss and longevity (health, behaviours, genes) are a big part of a robust retirement income planning.

Capacity for Loss (CFL)
In relation to CFL I will begin by quoting ATEB Consulting:

'First, advisers need to accept that assessing CFL is a regulatory requirement.

Second, advisers need to understand what CFL actually is - in COBS 9.2.2R, CFL is referred to as follows ...

' ... (advisers) 'have a reasonable basis for believing ... that the specific transaction to be recommended, or entered into in the course of managing ... is such that he is able financially to bear any related investment risks consistent with his investment objectives.'

Contrary to popular opinion, this means that CFL does not only relate to the client's 'standard of living', which normally focuses on income needs, but also relates to any capital objectives that the client might have, for example, purchasing a holiday home at retirement.

Third, advisers need to have a means of assessing CFL that actually works. Our experience indicates that NONE of the well-known risk tools deal with CFL remotely adequately. Some treat it as another flavour of ATR (degree of willingness to accept volatility), while others ask a few questions which are both leading and misleading at the same time'.

In essence, CFL should be assessed objectively and be quantified, including really drilling down into clients' reliance on their capital income and the potential financial difficulties that could be suffered if this income is reduced. As shown above providing a client with a clear understanding of the different stages of retirement and the potential changes to their expenditure needs should also assist with client understanding.

Longevity
The UK is getting older; in 2020, the Office for National Statistics (ONS) estimates that by 2066 one in four of the UK population will be aged 65 or over, while five million will be 85 or over (up from 1.6 million in 2016). This is creating a huge planning task for financial advisers, particularly as the number of retirees with final salary pensions is shrinking fast.

There are a number of longevity 'calculators' available to advisers available from the ONS and a number of UK insurance companies. Although the calculators available from insurance companies, such as the one available from Aviva,
https://www.direct.aviva.co.uk/myfuture/LifeExpectancy/AboutYou
are still relatively basic, it does allow a wider discussion regarding health and lifestyle to take place. No client is 'average' so I think advisers should look beyond the typical ONS life expectancy 'average' calculator used by many.

A new way of thinking
A different starting point is required to meet the needs of clients in retirement. The old adage of 'time in the market' goes out the window because being in the wrong markets at the wrong time can be devastating to a client's retirement hopes and dreams. So, from the very outset clients' investments should be positioned to avoid as many things as possible that could diminish capital in the short term, such as sudden downturns in equity markets.

Any solution should provide real returns above CPI to curb the impact of inflation and stop it eating away at future purchasing power.

In addition, as well as the FCA making the cost of drawdown products clearer and more comparable, they are mandating that from 2021 that each product provider must offer investment pathways for four different objectives:

1. I have no plans to touch my money in the next 5 years
2. I plan to use my money to set up a guaranteed income (annuity) within the next 5 years
3. I plan to start taking my money as a long-term income within the next 5 years
4. I plan to take out all my money within the next 5 years

To meet the FCA's requirements, you, as an adviser, will be required to evidence that you have considered each of the Investment Pathway Solutions available to your client and the suitability and value for money of any alternative investment recommendation you make.

"Distributors must ensure that the financial instruments and investment services they intend to distribute are compatible with the needs, characteristics and objectives of the identified target market."
PROD 3.3.15, FCA

Concerns
The FCA is clear that accumulation (saving up for retirement) and decumulation (drawing down in retirement) are different and have different associated risks e.g. sequence of return risk.

That may not necessarily mean using different portfolios but will most likely involve different investment strategies: not what the investment components are, more how they are used.

Understandably, the FCA is very interested in how this market operates. To ensure that good outcomes are being delivered, the FCA flagged interest in the 2019 Sector Review paper:

"Some adviser firms have not yet updated their investment strategies for decumulation clients. In addition, they may not have adequately considered decumulation risks".

*70% of planners are using different funds for retirement clients**

***Ascentric, Centralised Retirement Propositions, March 2020**

A PROD from the FCA

To misuse further acronyms, the needed push towards the implementation of a different way of thinking could come as a result of the introduction of MiFID II. PROD, or the Product Intervention and Product Governance Sourcebook to give its full title, is designed to improve firms' product oversight and governance processes. This new sourcebook is relevant to both manufacturers and distributors of products, but PROD 3.3.15 applies specific rules in relation to segmentation and target markets. There is a need to ensure the 'needs, characteristics, and objectives' of clients are compatible with an investment proposition.

Ongoing suitability of investments under the microscope

There are obviously many other planning considerations at play here. Many advisers are already aware that they are responsible for reviewing the ongoing suitability of the investment solution, but this has been brought into even sharper focus in light of the material change in valuations and potential client circumstances. It is more important than ever that advisers review clients' risk tolerances as well as income and expenditure needs to determine whether income sustainability can be improved over both the short and long term.

Ultimately, advisers need to demonstrate that their process is robust and set-up to deliver good client outcomes and also against client expectations. In the current environment, it makes perfect sense to review the robustness and appropriateness of whatever investment solution you use in your CRP, or CIP for that matter. That should start with a review of the client's individual objectives through to the investment portfolio's overall construction, risk metrics and governance.

Evidencing sustainable withdrawal rates

There have been many research papers in recent years (Bengen, Morningstar, Institute and Faculty of Actuaries et al) looking at finding the elusive 'magic number', with figures ranging from 2.5% to 4%, all with reasoned arguments to back it all up.

The issue though seems to be where these assumptions and calculations start. As we have already stated everything should start with the individual client and their personal position, not the mass market or averages. Every client will have their own requirement for income, their views on what core (essential) income is, their own mix of pension savings, debts and liabilities, their own needs and circumstances, their own views on what investment risks are acceptable. It will be different for everyone and so everyone will have their own view on Safe Withdrawal Rate (SWR).

One way to define, and evidence, the SWR applicable to each individual is to approach it from two perspectives.

1. Ask the client to define their income needs split between core and essential expenditure, and discretionary spending.
2. Understand and establish the 'controls' for each income stream. There are several moving parts that can explicitly define how the SWR is arrived at for each income stream.

The first part employs fairly straight forward budget planning, assessing how much income is needed to match the different income needs in retirement. Once this exercise is carried out there is an income figure allocated for each component.

The next stage is to consider the 'inputs'; these are the mechanics that drive the inputs into the adviser's modelling system, which can be typically:

Time horizon – How long is the income stream needed for? Generally, the longer the time period, then the lower the SWR will be.

Inflation assumptions – If the income is covering ongoing bills and living expenses, then linking this to CPI/RPI is vital to maintain purchasing power over time. This also has an impact on the SWR.

Portfolio asset allocation – This considers the risk asset (equities etc.) exposure that is supporting the income stream. It is generally accepted that if a level of risk asset exposure the SWR can be higher. However this needs to reflect the purpose of the income and CFL available.

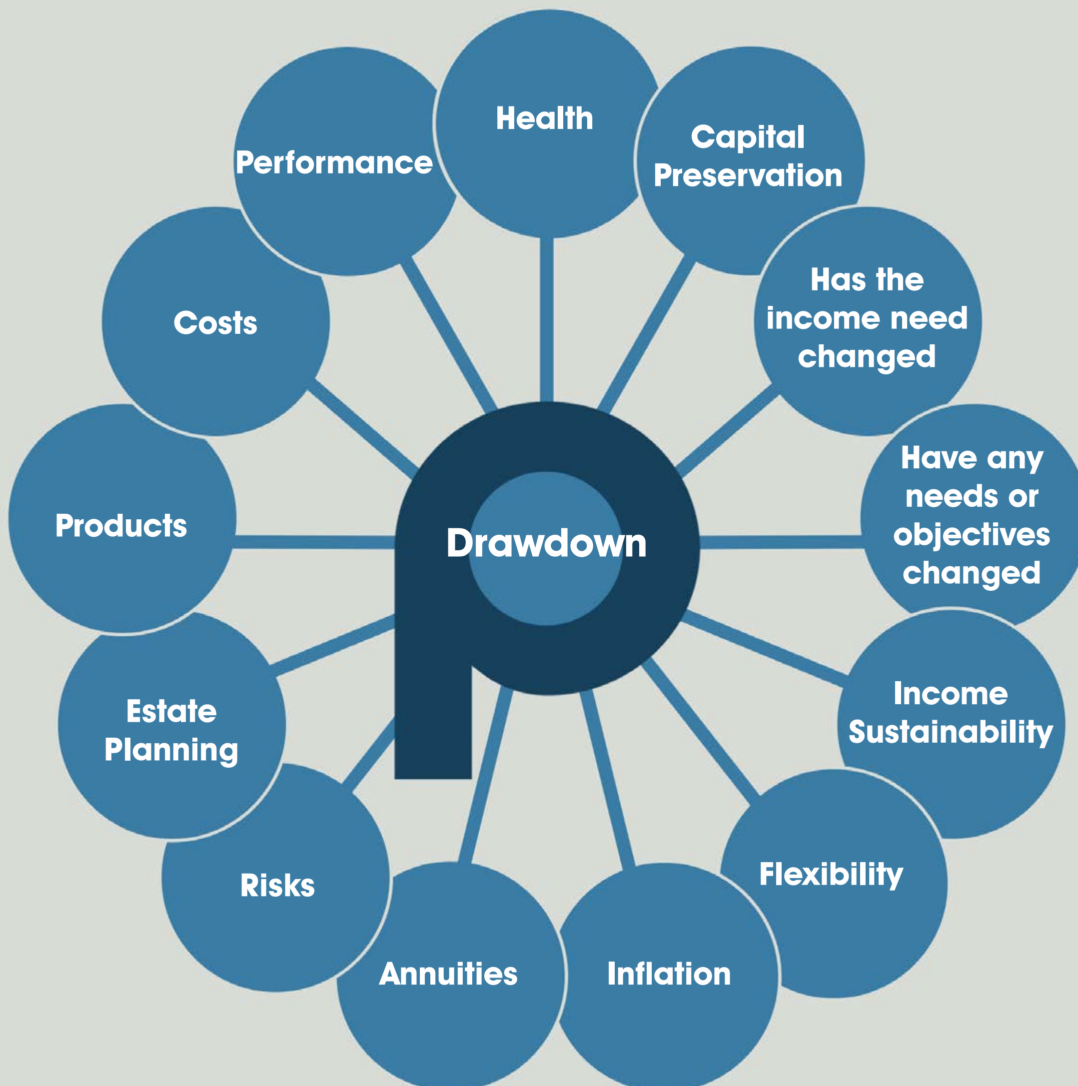
Levels of essential (core) income required – This may require a mix of guaranteed and flexible income for core and discretionary expenditure.

Fees and charges – To obtain a realistic SWR, full costs need to be factored in, including platform fees, fund charges and ongoing adviser fees, apportioned across the income streams.

Probability of success – This defines the desired probability of a successful outcome. For essential expenditure it's likely to be close to 100%, but for discretionary spending could be lower to reflect lower importance. Monte Carlo simulation is the ideal tool for this.

Drawdown is not a product!

Client circumstances will always evolve. This will impact on the drawdown objectives and therefore they need to be reconsidered periodically. The key factors to consider during every drawdown review are shown below:



Source: Defaqto

What does a good CRP look like?

CIPs are structured investment processes that aim to deliver a robust solution that is both repeatable and consistent for different clients.

CRPs recognise that there are key differences between building a fund of money before retirement and applying that money during retirement to provide an income for life.

It is not essential to develop a CRP to manage these risks, but it makes sense to adopt a consistent, structured approach.

Every advice firm will have a different decumulation strategy, but they are likely to include a number of common elements such as information on longevity, detailed assessment of risk and ability to bear losses, detailed expenditure analysis, evidence to validate sustainable withdrawal rates and strategy to manage sequence risk.

It is vital that you have a robust evidence-based process that covers all the issues your clients face as they enter retirement and it is applied consistently across your firm.

A framework for providing retirement planning advice

Clearly CRP's need to go much further than just being a CIP for retirement clients. In fact it is less about the investment component in a CRP, and more about the overall robust framework being put in place to provide retirement planning advice to your retirement clients.

As the popularity in drawdown continues to soar and the regulatory focus continues to gather momentum, it's hard not to see adviser CRP adoption increasing further. We believe the example framework shown below is a good starting point:

Obviously, a robust retirement framework needs to include an investment strategy and serious consideration should be given to how you to meet the evolving needs of your different retirement clients. In all likelihood this probably means differentiating your investment strategy for accumulation and retirement clients. But the investment strategy is only the tip of the iceberg within a CRP framework.

That is because, as mentioned above, the CRP needs to encompass the whole process in providing retirement planning. For example, adopted processes for fact-finding, assessing your retirement clients' attitude to risk and capacity for loss as well as managing other retirement considerations such as sequencing risk, income withdrawal rates, longevity and income sustainability. In addition to all that, a CRP framework should also take into the account the retirement product being used. When you take all this into account, it becomes apparent that a CRP is much broader and very different to a CIP approach.

In this context, you may already have a robust CRP in place without actually realising it. If not, I'd strongly encourage you to think about any gaps you might have because building out a robust process can help you manage all of those inter-connected retirement issues and challenges as well as addressing certain regulatory concerns which we'll take a look at in the next instalment of this series.

A CRP can deliver similar benefits to a CIP in terms of consistency and efficiency, but the real benefit is using the whole framework to help clients plan for a sustainable retirement. As we all know all too well, clients' needs vary considerably in retirement and having a CRP in place, with more in-built flexibility relative to a CIP, can help you continue to meet those evolving needs in a more efficient manner.

Asking yourself questions such as the ones below can also lead to better client outcomes. Indeed after asking the second question I found a number of basic longevity calculators offered by UK and US based insurance firms online which take the calculation above the typical ONS 'averages' normally quoted.

Do you have a process in place for vulnerable clients?

How are you assessing longevity risk, income sustainability and capacity for loss?

Does your process include an ongoing CRP review?

Do you have the processes in place to review your drawdown clients' suitability more frequently?

Regulatory concerns

The FCA detailed in their business plan for 2020-21 that the suitability of drawdown advice remains one of its key priorities. Furthermore, their 'Dear CEO' letter towards the end of January 2020 highlighted this concern around the suitability of advice and that they essentially want retirement consumers to have access to 'high quality advice and support'.

'High quality advice and support' happens to be a bread and butter service that many of the adviser firms that I've met provide to all of their clients, not just retirement clients but there is also this inter-connected issue of PROD which requires advisers to tailor their investment solutions and products to meet the needs of target markets.

With COBS 9.3.3, dealing with income withdrawals, short-term annuities and uncrystallised funds pension lump sum payments confirming:

When a firm is making a personal recommendation to a retail client about income withdrawals, uncrystallised funds pension lump sum payments or purchase of short-term annuities, it should consider all the relevant circumstances including:

1. *The client's investment objectives, need for tax- free cash and state of health;*
2. *Current and future income requirements, existing pension assets and the relative importance of the plan, given the client's financial circumstances;*
3. *The client's attitude to risk, ensuring that any discrepancy is clearly explained between*
4. *His or her attitude to an income withdrawal, uncrystallised funds pension lump sum payment or purchase of a short-term annuity and other investments*

The FCA have also recently built upon this with the announcement of 'Assessing Suitability Review 2'. The wide-ranging review will focus on initial and ongoing advice to consumers on taking an income in retirement.

The key areas that the FCA suggested advisers need to be aware of includes:

- Ensuring advice you provide is suitable, costs and charges are disclosed clearly, and you act in the best interests of your clients.
- Conflicts of interest must be identified and where they cannot be prevented, disclosed and managed.
- Inadequate fact finding creates a high risk that your advice will be unsuitable.

Some key areas that advisers will need to consider are:

- How are you assessing and managing a sustainable withdrawal rate for clients? If you are using a cash flow modelling tool, what assumptions are being used?
- If you are relying on “natural income”, how will your client cope when income rates are low, or when income amounts fluctuate?
- How are you helping clients to manage behaviour risk (taking too much out) or coping with possible lower returns than expected?
- How have you assessed your selected platforms capability to manage, change and pay income?
- How have you considered any income guarantees (state pension & Defined Benefit) versus the need for flexibility? Have you secured any later life income needed?
- Post pensions freedoms, retirement fact finding will need to have been updated – it is worth checking that you are capturing both hard and soft facts.

Helping your clients better understand the risks
Regardless of whether a firm is using a CIP, a CRP firm needs to evolve and adapt their processes for drawdown clients to help manage all of those inter-related risks and challenges in retirement. This can help you understand more about how different investments will perform in different scenarios whilst ensuring your clients have a better understanding of the risks they face in retirement. It also helps paint a clearer picture to your clients about how you are managing these risks for them and striving for stronger client outcomes.

As we have already discussed, a CRP is a much more sophisticated vehicle than just taking a CIP and swapping the investment fund for one aimed at retirement clients. Retirement advice is fundamentally different to advice in accumulation and a CRP framework reflects those key differences.

The impact of sequencing risk and volatility drag on retirement clients taking a regular income continues to present a significant challenge for advisers and having a robust process in place to review income sustainability is perhaps more significant than ever before.

Appendix – A Checklist for Developing a CRP

Below is a checklist of the areas to consider when developing a CRP or retirement planning process:

- PROD: Is it documented. Is it embedded in your DDQ?
- Evidencing value for money - FCA consultation paper CP20/9
- Cashflow Tool: Do you use one. What are the assumptions within it?
- Retirement Fact Find: Updated date. Does it include soft facts?
- Annuity Rates: Checked rates. Update frequency?
- Safe Withdrawal Rate: Rate used. Consistency. Evidence?
- Cash Buffer: Yes or No? How held (on/off platform). How much?
- Risk Profiling: ATR. C4L. Need for Return. Risk tool Due Diligence?
- Inflation Assumptions: Rate used. Evidence?
- Taxation and allowances considerations: Income Tax and Lifetime Allowance etc.
- Sequence Risk: Understanding and explaining it. Mitigation Strategy?
- Investment Philosophy: Is it documented. Evidence?
- Investment Service: Pots or Single? Small Pots. Evidence/DDQ?
- Adviser Service Offer: PROD segments. Drawdown service?
- Adviser Fees: £s or %. Small pots. Long Term. Documentation?
- Platform for Drawdown: Checklist (PROD and Service). DDQ?
- Client Understanding: Process. Simplicity. Documentation?
- Vulnerable Clients: Statement. Process. Documentation?
- Conflicts: Issues. Management strategy?
- Showing Your Value: Examples. Communication?