Converting pension pots into incomes:

Are current roads into retirement delivering member value?

Research commissioned by HSBC Tomorrow Master Trust - undertaken by Professor Andrew Clare of Bayes Business School, in association with Hymans Robertson.

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Forward

As elsewhere, the pensions world is in a very different place than it was, even compared to a few months ago. We have new member value regulations to meet, there's (yet another) newly-installed government and, more seismically, the economic landscape has changed. No doubt, all of this will impact policy in both the short and long-term. That said, some things have not changed. Pension savers still need good value solutions that can fit into their lives and work for them. A sense of security and trust also remains a must. These are just a few of the reasons why I've been so passionate in helping to build a forward-thinking solution that looks to drive better and secure outcomes for people's financial future.

Part of that forward-thinking is about identifying areas in a pension saver's journey that are often forgotten or ignored. One such area is the friction, cost and risk that members face as they enter retirement for the first time. I would like to thank Professor Andrew Clare and Hymans Robertson for taking up this too-often overpassed mantle to reveal the real-term impact members are exposed to during this crucial moment in their lives, as well as ways we can fix and enhance value in this area. I'm sure you will agree that Andrew's findings are, to say the least, eye-opening.

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About the author
Andrew Clare is Professor of Asset Management at Bayes Business School (formerly Cass). He is also a Trustee and Chairman of the Investment Committee of the £3.5bn Magnox Electric Group Pension scheme. Andrew also serves as an independent Non-Executive Director on Legal & General's Unit Trust Management Board. Before returning to academia he worked as a Senior Research Manager in the Monetary Analysis wing of the Bank of England, which supported the work of the Monetary Policy Committee. He is the co-author of "The Trustee Guide to Investment", and has published extensively in both academic and practitioner journals on a wide range of economic and financial market issues.

Alison Hatcher, CEO
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About HSBC Tomorrow Master Trust
Part of HSBC Retirement Services Ltd, the mission of HSBC Tomorrow Master Trust is to help set everyone on a path towards a better retirement. Because everyone faces different financial challenges throughout life, we believe that providing personalised support, education and financial wellbeing tools not only empowers individuals to save more for the things that are important today, it can awaken a world of opportunity for tomorrow. That's why we deliver a combined workplace pension and in-retirement solution to our members, with ongoing financial wellbeing support embedded throughout their journey with us.

Contents

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Introduction

UK citizens are losing around £1.7bn a year during their transition into retirement.

With annual Value for Member assessments now enforcing the need for pension schemes to evaluate and demonstrate member value, the debate about how value should be defined and delivered is widespread.

However, the transition journey into retirement, and the significant impact that this can have on a member's pot value, is an area still largely ignored. And while trustees do have a duty around communication at retirement (i.e. providing wakeup packs), there is still no requirement for providers to make any of the pension freedoms directly available from a scheme.

As it stands, members who transfer out in order to take retirement benefits generally move from an accumulation journey regulated by The Pensions Regulator to a retail environment under Financial Conduct Authority rules. Not only can this lack of ownership from governing bodies leave members open to risk and erosion of value (that has taken decades to grow), they are no longer protected by the fiduciary and value oversight responsibilities of employers and trustees.

Where members stand today

In total, UK citizens are losing around £1.7bn a year during their transition into retirement, according to data from Hymans Robertson.

This loss can arise when members withdraw amounts above the 25% tax-free threshold, because they are buying advised products that might not be the optimal solution, or paying transfer fees that come with moving assets from one provider to another.

At the same time, the overwhelming majority of single employer schemes, as well as a sub-set of contract schemes and master trusts, won't or can't offer in-scheme retirement solutions, forcing members to seek out products from third-party providers when they want to convert their pension pot into an income.

With members left to their own devices at a crucial moment in their lives, this often takes place without suitable guidance or advice.

The regulatory view

The current Value for Member assessment requires "a comparison of reported costs, charges and fund performance (net investment returns) with three other schemes, and a consideration of key governance and administration criteria" from qualifying schemes.

A requirement to look to future member needs is also included, but the current language indicates a fragmented approach rather then an holistic strategy that includes the transtion into retirement as one of the fundamental measures of member value.

The role of sponsors and trustees

Research by Hymans Robertson reveals that while around half of DC schemes currently point their members towards third parties with annuity brokering services, few of these offer in-scheme drawdown solutions.

Procurement processes are also narrowing, as regulators look for responsible parties to focus on the shape of a scheme's investment strategy, ongoing management charges and communication channels (e.g. paper, online, apps etc).

As pension pots grow in value in years to come (due to the success of auto enrolment), these value measurements may soon prove insufficient.

Preserving pension pot value

Is a scheme's investment strategy designed to meet the evolving needs of members who are entering or in retirement? What are the true costs that members face when they enter retirement (i.e. entry/exit charges, frequency of rebalancing, transaction costs)? Is there a seamless way to enter retirement? If not, where are the friction points and what risks could they expose members to?

These are just a few questions that trustees and corporate sponsors need to ask themselves when they tackle the issue of member value and gauge whether fiduciary duties can and will be fulfilled as member needs change and new regulations are introduced over time.

As it stands today, Trustees are not required to address these matters.

Executive summary

Current roads into retirement are eroding the value created over a member's life time - at a single point and in real terms - while effectively ignoring risk exposure as schemes abandon members at a critical life stage.

It should be our collective fiduciary duty to consider how member needs have evolved and will change, while removing current rigidity around our perspective of value over time.

Recommendations

This report presents data on the cost and value impact that comes when DC pension scheme members convert their pot(s) into a retirement income in the UK.

Comparing different groups of retirement savers, varied by age, salary, wealth and their normal retirement age, with the different ways they can choose to access their savings at retirement, this report models the likely impact transitioning into retirement can have on a retirement income in terms of friction, costs, pot exhaustion risk and a member's peace-of-mind.

Born out of this research are a list of recommendations to corporate sponsors, pension providers and government bodies that can help remove frictional costs during the transitional phase into retirement, provide more clarity around delivering value for trustees, and ultimately provide a long-term value uplift for members ahead of, at and in retirement. Key recommendations are summarised below:

Extend auto-enrolment provisions to cover retirement solutions

This should include employers and trustees being given the responsibility to provide a cost-effective retirement solution. This would reduce the risk to members at no extra cost to the employer, enhance corporate models by ensuring employees have an intuitive and efficient pathway into retirement, and enhance (at no cost) the value of benefit packages.

Deliver more clarity and guidance around the scope of "value"

Value for members is currently being reviewed by the regulator, with subjective insight coming through consultations. Further use of Master Trust frameworks could provide simpler and more objective oversight of the industry, as well as management of the regulatory regime at this crucial part of the retirement journey. This would reduce risk in the market and help remove the governance burden.

Provide examples of optimal solutions and best practise for trustees and employer

This could assist decision making and provide clear benchmarks, helping to achieve market objectives and enhanced standards. Not only will this help drive better member value, more innovative and competitive markets will emerge – something which, in turn, should further enhance value for members.

Market overview

The introduction of pensions Freedom and Choice in 2015 was a dramatic change to the UK pensions system. Overnight, lifetime income (annuity) products purchased from an insurance company were no longer the dominant road into retirement. Members can now access their pension savings in a way that best suit their needs.

The Work and Pensions Committee's review of Freedom and Choice published in January 2022 concluded that, on balance, the changes have been a success, but recognised the challenging decisions that members need to take at retirement. The review made specific recommendations about the need to improve decision support for members as they approach retirement.

Since the introduction of Freedom and Choice, the Financial Conduct Authority (FCA) has tracked the behaviours of members entering drawdown for the first time.

While in-scheme drawdown products from trust-based solutions are relatively new, a significant sub-set of single-employer and contract-based schemes still require members to find a third-party in order to convert their plan into a retirement income.

Retirement advice engagement
The total number of pension plans accessed for the first time in 2021/22 increased by 18% to 705,666 compared to 2020/21, according to the FCA. Fifty-six per cent were taken as one full withdrawal, while 29.1% entered drawdown.

Of those plans taken as one full withdrawal, more than two thirds (65%) took place without financial advice provided to members. This is compared to 54% of plans worth less than £50,000 being converted into a drawdown income after financial advice was provided.

This FCA data complements the Work and Pensions Committee's finding that more needs to be done to support an individual's specific needs as they approach retirement.

The Financial Advice industry provides a valuable service for individuals who want to plan for retirement and access their retirement savings tax-efficiently. However, the reality is that the many individuals with small pots wanting to convert their plans into a regular income do not have sufficiently complex needs to warrant full adviser charging.

Guidance or low-cost advice propositions in conjunction with the ability for individuals to leave their DC pots invested in cheap, well governed products are likely to lead to much better retirement outcomes for many individuals.

Full withdrawal and financial advice

395,237

Number of plans fully withdrawn when accessed for the first time in 2021/22

65%

Percentage of plans fully withdrawn for the first time **without** financial advice in 2021/22

Drawdown and financial advice

205,641

Number of plans converted into a drawdown income for the first time in 2021/22

54%

Percentage of plans worth less than £50,000 converted into a drawdown income for the first time **with** financial advice in 2021/22

Report methodology

This report analyses the difference in retirement outcomes for individuals with less complex retirements.

Different cohorts of retirement savers and the different paths they could take to convert their pension into an income were considered:

1. Assets are saved in an employer-sponsored scheme and then transferred to and withdrawn from an actively-managed fund within an advised retail drawdown solution.

2. Assets are saved in an employer-sponsored scheme and then transferred to and withdrawn from a passively-managed fund within an advised retail drawdown solution.

3. Assets are saved in an employer-sponsored scheme and then transferred to and withdrawn from a Master Trust that includes drawdown income solutions.

4. Assets are saved, converted and withdrawn within a multi-employer workplace Master Trust that includes friction-free in-scheme drawdown solutions.

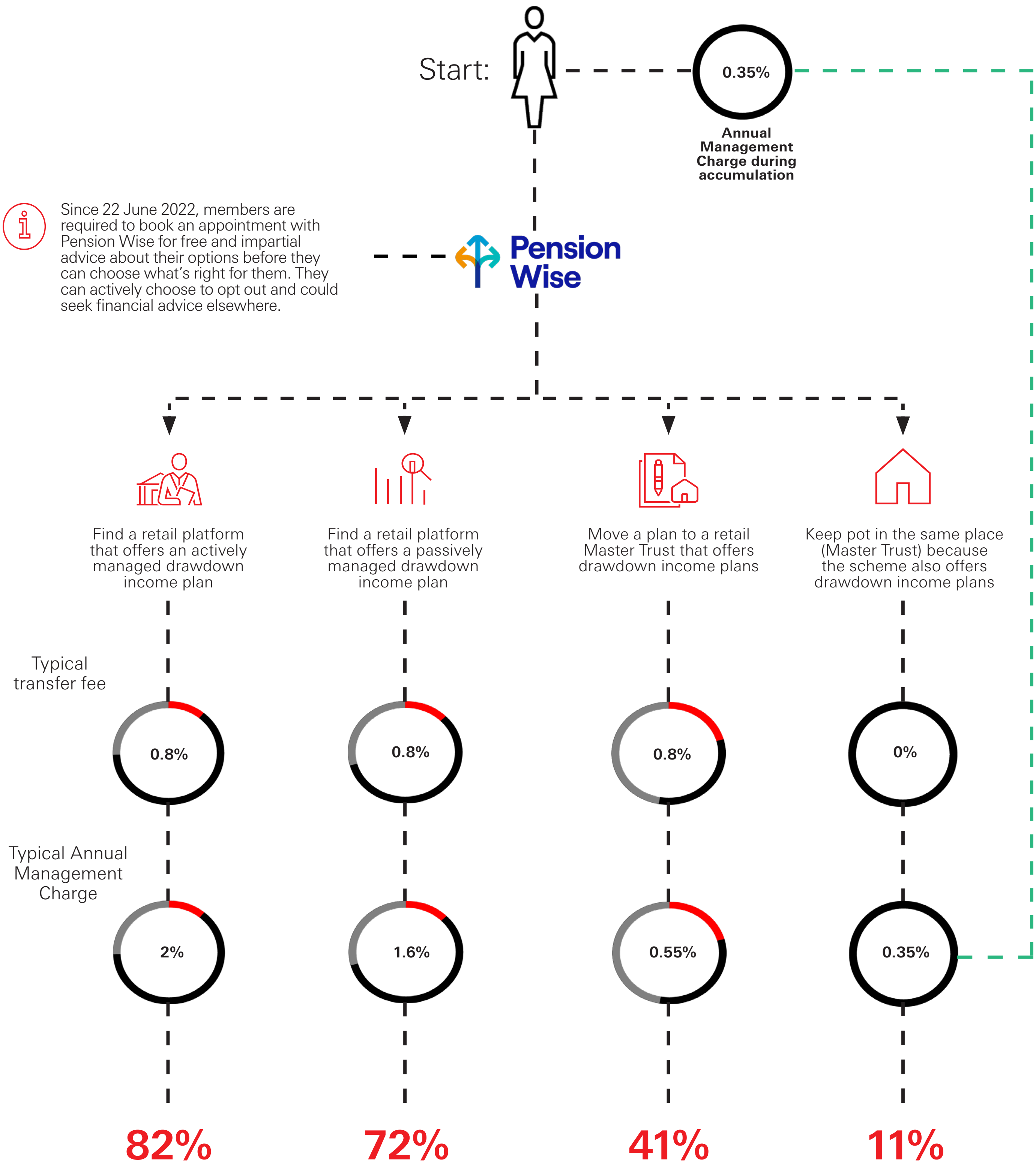
To help understand the likely impact of the different choices that retirees can make at retirement, this report models both the decumulation options described above and financial market returns.

Having modelled the above options and financial market returns, a number of representative individuals were developed, who broadly represent: a baby boomer; a Gen X, a Millennial and a Gen Z individual. The financial position of each of the cohorts were developed with the help of Hyman Robertson.

Results

Almost a year's worth of income (up to 82%) could be lost during retirement if a pension saver needs to convert their pension pot into a drawdown plan through another provider - increasing the chances of running out of money when they reach 90 by up to 18 per cent.

Friction points on the road into retirement



Percentage of a member's first year retirement income required to pay transition fees and AMCs, based on a 4% annual withdrawal.

This is a results summary of the report's Baby boomer 1 member profile (see page 12)

Baby boomer 1

Age:	65
Retirement:	Within 12 months
Current annual earnings	£20,000
Pot value at retirement:	£35,000
Tax-free lump sum at retirement:	Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	**2.80%**	£779 (4% withdrawal)	0.8%	2%	82% (£639)	85%
Transfer pot to a passively managed drawdown plan	**2.40%**	£787 (4% withdrawal)	0.8%	1.6%	72% (£564)	88%
Transfer pot to a retail Master Trust drawdown plan	**1.35%**	£792 (4% withdrawal)	0.8%	0.55%	41% (£324)	93%
Drawdown option within existing Master Trust scheme	**0.35%**	£800 (4% withdrawal)	nil	0.35%	11% (£87)	96%

Baby boomer 2

Age:	65
Retirement:	Within 12 months
Current annual earnings	£45,000
Current pension pot value:	£150,000
Tax-free lump sum at retirement:	Yes

Results at retirement:

Option	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	**2.80%**	£3,235 (4% withdrawal)	0.8%	2%	81% (£2,621)	84%
Transfer pot to a passively managed drawdown plan	**2.40%**	£3,243 (4% withdrawal)	0.8%	1.6%	71% (£2,301)	87%
Transfer pot to a Master Trust managed drawdown plan	**1.35%**	£3,262 (4% withdrawal)	0.8%	0.55%	41% (£1,335)	95%
Drawdown option within existing Master Trust scheme	**0.35%**	£3,291 (4% withdrawal)	nil	0.35%	11% (£355)	95%

Generation X 1

Age:	55
Retirement:	67
Current annual earnings:	£22,000
Current pension pot value:	£40,000
Tax-free lump sum at retirement:	Yes

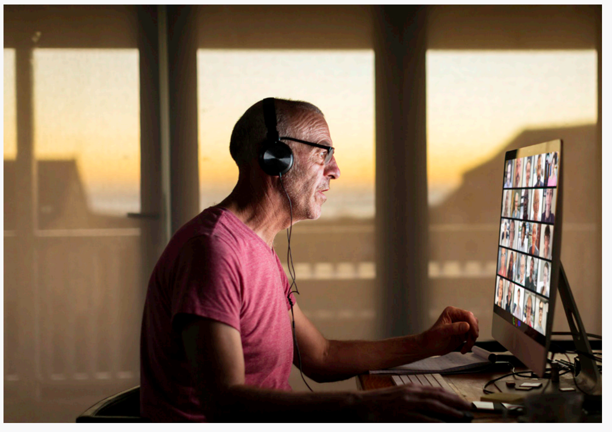
Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	**2.80%**	£3,726 (4% withdrawal)	0.8%	2%	65% (£2,421)	77%

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to a passively managed drawdown plan	**2.40%**	£3,606 (4% withdrawal)	0.8%	1.6%	56% (£2,019)	81%

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to a Master Trust managed drawdown plan	**1.35%**	£3,651 (4% withdrawal)	0.8%	0.55%	32% (£1,178)	91%

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Drawdown option within existing Master Trust scheme	**0.35%**	£3,676 (4% withdrawal)	nil	0.35%	9% (£320)	92%



Generation X 2

Age:	55
Retirement:	67
Current annual earnings:	£51,000
Current pension pot value:	£125,000
Tax-free lump sum at retirement:	Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	**2.80%**	£10,122 (4% withdrawal)	0.8%	2%	64% (£6,430)	75%
Transfer pot to a passively managed drawdown plan	**2.40%**	£10,217 (4% withdrawal)	0.8%	1.6%	55% (£5,640)	81%
Transfer pot to a Master Trust managed drawdown plan	**1.35%**	£10,604 (4% withdrawal)	0.8%	0.55%	32% (£3,442)	90%
Drawdown option within existing scheme	**0.35%**	£10,527 (4% withdrawal)	nil	0.35%	9% (£908)	93%

Millennial 1

Age: 35
Retirement: 68
Current annual earnings: £33,000
Current pension pot value: £15,000
Tax-free lump sum at retirement: Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	**2.80%**	£18,342 (4% withdrawal)	0.8%	2%	67% (£12,328)	74%

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to a passively managed drawdown plan	**2.40%**	£18,559 (4% withdrawal)	0.8%	1.6%	57% (£10,530)	78%

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to a Master Trust managed drawdown plan	**1.35%**	£18,353 (4% withdrawal)	0.8%	0.55%	33% (£6,031)	90%

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Drawdown option within existing Master Trust scheme	**0.35%**	£18,893 (4% withdrawal)	nil	0.35%	9% (£1,626)	91%

Millennial 2

Age: 45
Retirement: 68
Current annual earnings: £36,000
Current pension pot value: £20,000
Tax-free lump sum at retirement: Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	2.80%	£8,340 (4% withdrawal)	0.8%	2%	68% (£5,649)	74%
Transfer pot to a passively managed drawdown plan	2.40%	£8,153 (4% withdrawal)	0.8%	1.6%	58% (£4,698)	78%
Transfer pot to a Master Trust managed drawdown plan	1.35%	£8,130 (4% withdrawal)	0.8%	0.55%	33% (£2,702)	90%
Drawdown option within existing Master Trust scheme	0.35%	£8,398 (4% withdrawal)	nil	0.35%	9% (£732)	91%

Millennial 3

Age:	45
Retirement:	68
Current annual earnings:	£36,000
Current pension pot value:	£60,000
Tax-free lump sum at retirement:	Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	**2.80%**	£13,283 (4% withdrawal)	0.8%	2%	67% (£8,888)	74%
Transfer pot to a passively managed drawdown plan	**2.40%**	£12,619 (4% withdrawal)	0.8%	1.6%	57% (£7,253)	80%
Transfer pot to a Master Trust managed drawdown plan	**1.35%**	£13,222 (4% withdrawal)	0.8%	0.55%	33% (£4,318)	88%
Drawdown option within existing Master Trust scheme	**0.35%**	£13,324 (4% withdrawal)	nil	0.35%	12% (£3,925)	90%

Generation Z 1

Age:	22
Retirement:	69
Current annual earnings:	£22,000
Current pension pot value:	£0
Tax-free lump sum at retirement:	Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	2.80%	£32,632 (4% withdrawal)	0.8%	2%	92% (£29,977)	83%
Transfer pot to a passively managed drawdown plan	2.40%	£32,207 (4% withdrawal)	0.8%	1.6%	78% (£25,994)	86%
Transfer pot to a Master Trust managed drawdown plan	1.35%	£32,235 (4% withdrawal)	0.8%	0.55%	45% (£14,350)	93%
Drawdown option within existing Master Trust scheme	0.35%	£33,398 (4% withdrawal)	nil	0.35%	12% (£3,925)	95%

Generation Z 2

Age: 22
Retirement: 69
Current annual earnings: £13,000
Current pension pot value: £0
Tax-free lump sum at retirement: Yes

Results at retirement:

	Total costs for first year of retirement	Projected initial annual drawdown income	Transaction charge	Annual charge	Total charge equivilence to Year 1 income	Probability pot lasts until age 90
Transfer pot to an actively managed drawdown plan	2.80%	£19,737 (4% withdrawal)	0.8%	2%	92% (£18,137)	84%
Transfer pot to a passively managed drawdown plan	2.40%	£19,155 (4% withdrawal)	0.8%	1.6%	78% (£14,993)	89%
Transfer pot to a Master Trust managed drawdown plan	1.35%	£19,118 (4% withdrawal)	0.8%	0.55%	45% (£8,518)	94%
Drawdown option within existing scheme	0.35%	£19,828 (4% withdrawal)	nil	0.35%	12% (£2,329)	95%

Analysis

The baby boomers

The section headed "Probability pot lasts until age 90" presents an important statistic.

It represents the probability that the pensioner will still be able to draw an income from their plan by the time they reach 90. For Baby Boomers 1 and 2, who choose to stay with their employer-sponsored scheme, these probabilities are 95% and 96% respectively.

Statistics for the other withdrawal options are also presented. Because of the transaction fees and the asset allocation, the average pension income in each of these cases is lower.

More importantly, the failure rates at 90 are higher. For example, if Baby Boomer 2 chooses to transfer their pot to a typical IFA platform, making use of actively managed funds in retirement rather than choosing to stay in-scheme, the failure rate rises from 4.7% to 16.1%, that is, an approximate trebling of the likelihood of running out of money.

There is relatively little to choose from transitioning to a third-party Master Trust or staying in-scheme with a Master Trust , although ultimately the failure rate is higher for the former due to the need to transfer to another provider.

However, the higher fees for the IFA platform solutions ultimately have a large impact on the likelihood of still being able to draw an income at age 90.

From these results, the income reduction that baby boomers would need to accept to achieve the same failure rate at 90 they would expect from staying in-scheme can be calculated.

Using Baby Boomer 2 as an example, they would need to reduce their annual income in year 1 of retirement by £1,305, an income loss that would increase to £2,653 by age 90.

Generation X

When Generation X 1 and 2 choose to stay in-scheme the failure rates at 90 are now 8.3% and 7.3% respectively.

These values rise by a factor of around three if the member chooses to transfer their pot out to an actively-managed drawdown plan, to 23.3% and 25.1% respectively.

There is now, approximately, a one in four chance of running out of money at 90. The income reductions that would need to be taken in order to achieve the same failure rates represent relatively substantial amounts of annual income.

The millennials

For Millennial pension savers 1, 2 and 3, the results also show that the probability of running out of money by age 90 is around 25%, compared with a figure of just under 10% if the member remains in-scheme.

The income losses to achieve a similar likelihood of failure are also quite substantial.

For example, for the Millennial 1 pension saver to achieve the same failure rate as could be experienced in-scheme, they would have to reduce their initial income by £5,088 in year 1 of retirement, a shortfall that would rise to £9,749 in the cohort's 90th year.

Generation Z

The projected annual drawdown incomes for Generation Z 1 and 2 look to be a relivately large. There are two reasons for this.

First, our representative cohort saves 10% of their income throughout their working life, starting at a very early age, 22. Second, Albert Einstein, once said: "Compound interest is the 8th wonder of the world. He who understands it, earns it; he who doesn't, pays it."

In the case of Millennial pension savers, they benefit from compounded investment returns for almost fifty years. However, having said this, all figures in this report are presented in nominal terms, and so the real value of the investment pot would depend on the rate of inflation over this period.

The projected failure rates for Generations Z1 and Z2 at age 90 are 5.5% and 4.7% respectively, when they remain in-scheme. These rates rise as the fees rise in the different drawdown arrangements.

If they choose to transfer out to an actively-managed pathway, they are 16.7% and 16% for the same cohorts respectively.

That means there would be a three and half times greater possibility that Generations Z1 and Z2 pension savers would run out of money by age 90.

Pension saver profiles

How members were profiled

In each case an assumtion was made that the representative member and/or their employer contributed a total of 10% of their gross salary to their pension pot prior to retirement.

As an example, Gen Z 1, who is currently 22 years old, earns a salary today of £22,000 p.a. But for most people this salary can be expected to grow over time.

With that in mind, this research assumes that salaries grow over time according to the following rule:

- Prior to the age of 45, a member's salary grows at 4% each year
- After age 45 the salary grows at 2% per annum

The faster growth of a person's annual salary before age 45 reflects a typical age/earnings profile of a UK employee today. Typically, earnings grow faster in the early stages of a person's career and then plateaus around their mid-40s*.

Retirement income and the tax free cash lump sum

At retirement, the research assumes that all of these typical pension savers take 25% of their accumulated pot as a tax free cash lump sum. The remaining value (75% of the final pot) is converted into a pension income.

This research also assumes that pension income is taxed at a rate of 20%.

Finally, this research assumes that these typical pension savers drawdown 4% of the initial value of their pension.

This withdrawal then rises every year in retirement by 3%. For example, if an individual draws down £4,000 in year 1, they will drawdown £4,120 in year 2, and £4,243.60 in year 3, etc.

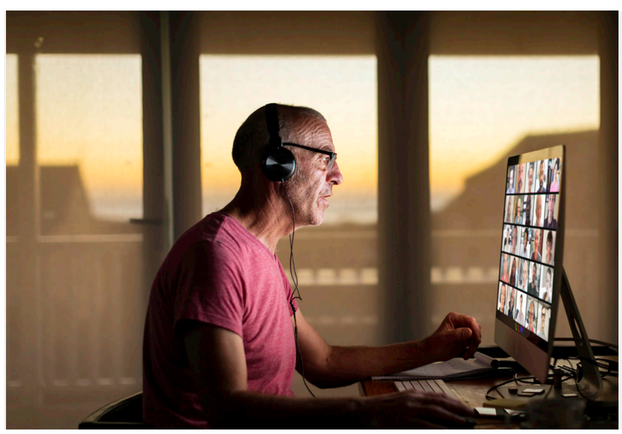
*For a more precise age/earnings profile for UK employees please refer to the government's ASHE survey (Annual Survey of Hours and Earnings (ASHE)).

Profiles for a number of typical pension savers have been developed. They vary by age, salary, wealth and by their normal retirement age. Together they give a broad picture of the impact that decumulation choices can have on retirement outcomes.

Baby boomer 1
Age: 65
Normal Retirement Age: 66
Annual earnings: £20,000
Current pension pot: £35,000

Baby boomer 2
Age: 65
Normal Retirement Age: 66
Annual earnings: £45,000
Current pension pot: £150,000

Generation X 1
Age: 55
Normal Retirement Age: 67
Annual earnings: £22,000
Current pension pot: £40,000



Generation X 2
Age: 55
Normal Retirement Age: 67
Annual earnings: £51,000
Current pension pot: £125,000

Mellennial 1
Age: 35
Normal Retirement Age: 68
Annual earnings: £33,000
Current pension pot: £15,000

Mellennial 2
Age: 45
Normal Retirement Age: 68
Annual earnings: £36,000
Current pension pot: £20,000

Mellennial 3
Age: 45
Normal Retirement Age: 68
Annual earnings: £36,000
Current pension pot: £60,000

Generation Z 1
Age: 22
Normal Retirement Age: 69
Annual earnings: £22,000
Current pension pot: £0

Generation Z 2
Age: 22
Normal Retirement Age: 69
Annual earnings: £13,000
Current pension pot: £0

The investment choices that were modelled

The member journeys analysed in this report are as follows:

1. **Transfer to a retail investment platform that provides an actively managed drawdown plan**
A member moves their pension pot from their employer's scheme to a retail investment platform, which includes advice from a Financial Advisor who invests their savings in actively managed investment vehicles.

2. **Move to a retail investment platform that provides a passively-managed drawdown plan**
A member transfers their pension pot from their employer's scheme to a retail investment platform, which includes advice from a Financial Advisor who invests their savings in passive investment vehicles.

3. **Transition to a third-party Master Trust**
A member transfers their pension pot from their employer's scheme to a third-party Master Trust that is available to retail customers.

4. **Stay in-scheme (a workplace Master Trust)**
A member has the option to remain within their existing Master Trust provided through their employer by converting their plan into an in-scheme drawdown solution.

Costs that members can face when they convert their pension pot into an income

Hymans Robertson estimated the typical costs associated with common roads into retirement.

There is a transaction cost involved in transferring out at retirement unless a member can stay in-scheme.

If the member stays in-scheme, we assume members have the choice to convert their pot into an income within their existing scheme.

We assumed a typical transaction cost is 0.8% of the value of a member's pension pot at retirement.

While this value will vary depending upon a number of factors, Hymans Robertson has concluded this to be a typical cost to transfer.

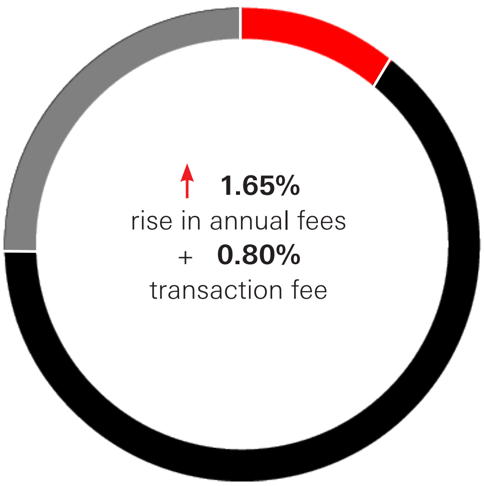
The average annual fees during a member's retirement also vary depending upon the path they take.

Our modelling found that if a member:

- Moves their pension pot to a retail investment platform with active investment options, fees rise from 0.35% p.a. pre-retirement to 2.0% p.a. in retirement.
- Transitions their pension pot to a retail investment platform with passive investment options, fees rise from 0.35% p.a. pre-retirement to 1.6% pa in retirement.
- Chooses to shift their pension to a third-party retail Master Trust, fees rise from 0.35% p.a. pre-retirement to 0.55% p.a. in retirement.
- Stays within their existing scheme (a workplace Master Trust) to take a retirement income, fees p.a remain fixed at 0.35% in retirement.

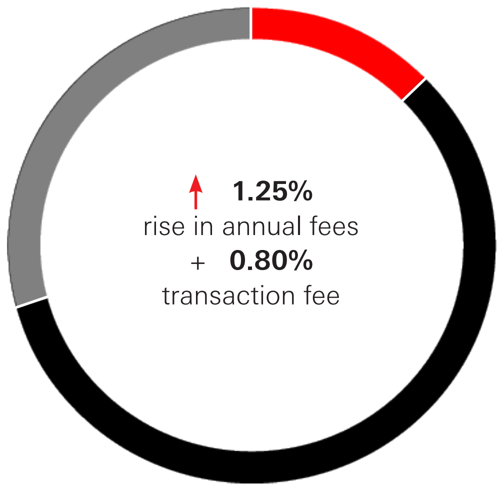
Cost increases at and in retirement based the route a member takes to convert their pension plan into an income:

Actively managed retail drawdown plan



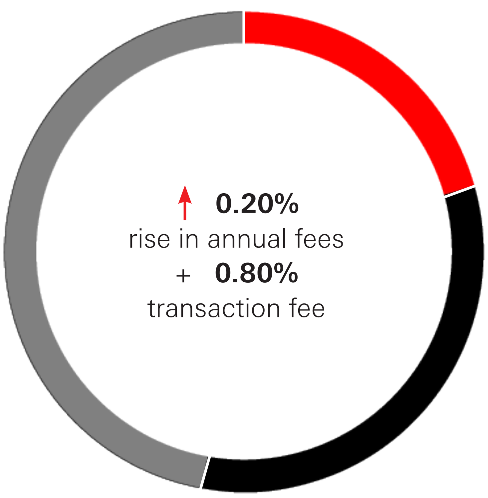
- Annual fee (pre-retirement) – 0.35%
- Annual fee (post-retirement) – 2.00%
- Transaction fee – 0.80%

Passively managed retail drawdown plan



- Annual fee (pre-retirement) – 0.35%
- Annual fee (post-retirement) – 1.60%
- Transaction fee – 0.80%

Retail Master Trust managed drawdown plan



- Annual fee (pre-retirement) – 0.35%
- Annual fee (post-retirement) – 0.55%
- Transaction fee – 0.80%

In-scheme Master Trust managed drawdown plan

- Annual fee (pre-retirement) – 0.35%
- Annual fee (post-retirement) – 0.35%
- Transaction fee – 0.00%

The investment choices we modelled

To gauge the impact that each route could have on the retirement experience of our typical pension savers, a set of asset classes and proportions allocated over time has been defined.

Financial market returns
The choice of asset classes for today's pension savers is very large and growing by the day. However, this report has defined a simplified set of asset classes that should capture the main risk-return characteristics available to pension savers. Two risky asset classes are specified.

The first has all the risk and return characteristics of an investment in developed economy equities. This asset class has an expected return of 8% and annual volatility of 15%.

In addition, this report allow each year's return to be partially dependent upon the previous year's return. This is a typical feature of equity market returns, but one that is often overlooked in simulation exercises.

The second risky asset class, has been designed to perform like a diversified growth fund. It has an expected return of 6%. This asset class has an equity market beta of 0.75. This means that it will tend to be only 80% as volatile as the equity market asset class.

Finally, this report also make cash available to our typical pension savers. But this asset class is only used in those instances where the representative saver is de-risking prior to retirement.

For simplicity this report assumes that Cash has an expected return of 2.0% p.a. with no volatility.

Asset allocation
An asset allocation for this report's typical pension savers needs to be assumed - in both the accumulation and decumulation phases. Once again, the asset allocations are considered to be typical and relatively straightforward.

For the "Stay in-scheme" pathway, this report assumes that up until five years to retirement the pension saver is invested 100% in developed economy equities.

Five years from retirement the pension saver gradually switches to the diversified growth fund. At retirement their savings are invested entirely in this diversified growth fund.

For the other frameworks, this report assumes a similar approach, but instead of using the multi-asset class investment to de-risk as they approach retirement, the individuals invest in Cash instead.

Simulating returns
For each of our typical pension savers, using the parameters specified above – starting pension pot, salary, normal retirement age, transaction costs, AMCs, asset allocation, income – this report uses Monte Carlo techniques to simulate the likely income in retirement that might be achievable.

For each typical pension saver group, and for each of the withdrawal options, the possible experience of these cohorts was simulated 1,000 times. This was to explore the possible outcome for 1,000 individuals in each pension saver group, but where each individual in the cohort experiences a different financial market environment.

However, it is important to note that the average returns experienced by each pension saver in the two risky asset classes are the same. Any difference in the end result for each pension saver depends then upon the sequence of these returns, not their average value.

Conclusion

Roads being taken today
The number of pension plans accessed for the first time increased by nearly a fifth (18%) in 2021/22, with the overall value of money withdrawn rising to £45,638m - up by 22%, according to the Financial Conduct Authority (FCA).

At the same time, two thirds (66.6%) of these plans were accessed by savers without any regulated advice, while full withdrawals rose by 16% to 395,237. Unsurprisingly, uncrystallised funds pension lump sums saw the largest surge – a 28% increase from 28,305 to 36,274.

These patterns of behaviour can be set against the cost of living crisis that is emerging in real terms for UK households. Indeed, a quarter of consumers say they would now withdraw pension savings to cover the cost of living, according to recent FCA research.

However, this report indicates that the 205,641 drawdown plans sold in 2021/22 (source: FCA) brought with them a detrimental rise in annual management charges combined with unavoidable transition fees – some totalling the equivalent of 82% of a first year income in retirement and increasing the chances of pot exhaustion when a member reaches age 90 by up to 18%.

At the same time, those scheme members who instead decided to make a full withdrawal are already likely to see a profound loss of purchasing power, with the Bank of England forecasting peak inflation at around 13% by the end of 2022 and continued “elevated levels” through 2023.

A glimmer of hope can be found for pension savers who are thinking about converting their pension pots into an annuity – as guaranteed income rates hit a 14-year-high (source: FT Adviser, 2022). With more interest rate rises expected over the next 12 to 18 months, annuity rates may continue to increase.

As the value of pension pots continue to rise, managing sequencing risk and providing a true “to and through” journey into retirement is where the real diversifiers are likely to emerge over the next decade.

Recommendations
Comparing the rise in drawdown purchases (24%) against annuity sales (13%) in 2021/22, this report indicates that the sequencing risk at the point of retirement is now one of the biggest detrimental factors for scheme members looking to convert their pension pot into a flexible income.

As it stands, corporate sponsors and trustees are neither obligated nor empowered to tackle this issue.

However, as the value of pension pots continue to rise (due to the undoubted success of auto enrolment), managing sequencing risk and providing a true “to and through” journey into retirement is where the real diversifiers are likely to emerge over the next decade.

This report concludes with a list of recommendations for corporate sponsors, the market and government bodies that can help provide both a short and long-term value uplift for members at and in retirement:

1. Extend auto-enrolment provisions to cover retirement solutions
The govetrnment has already suggested it is keen to see auto-enrolment expanded.

This should include employers and trustees being given the responsibility to provide a cost-effective retirement solution.

This would reduce the risk to members at no extra cost to the employer, enhance corporate models by ensuring employees have an intuitive and efficient pathway into retirement, and enhance (at no cost) the value of benefit packages.

2. Deliver more clarity and guidance around the scope of “value”
Further use of Master Trust frameworks will offer the regulator simpler oversight of the industry and management of the regulatory regime at this crucial part of the retirement journey.

This would reduce risk in the market and help remove the governance burden from employers and trustees.

3. Provide examples of optimal solutions and best practise for trustees and employers
This would assist decision-making and provide clear benchmarks, helping to achieve market objectives and enhanced standards.

Final thought
By implemeting these recommendations, we can not only help drive better member value, we can also create more innovative and competitive markets – something which, in turn, can only further enhance value for members.

HSBC Tomorrow Master Trust

Your workplace pension, retirement and financial wellbeing solution

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