BARNETT WADDINGHAM
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Briefing

"Walk this way?"

What will Investment Pathways mean for consumers and advisers?

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Investment Pathways were finally launched with effect from 1 February 2021, having been delayed from their original launch date of 1 August 2020 due to the coronavirus pandemic.

Investment Pathways have been developed by the Financial Conduct Authority (FCA), as part of their 'Retirement Outcomes Review' project, which commenced in 2016 in the wake of the 'Pension Freedoms' that were introduced with effect from 6 April 2015.

Together with warnings about holding too much cash within an underlying investment portfolio, Investment Pathways represent the FCA's solution to combatting potential financial 'harms' that could otherwise be experienced by individual consumers who elect to go into Flexi-Access Drawdown with their Defined Contribution (DC) pension funds from age 55 onwards, on a 'non-advised' basis.

Now that the Pathways have had a number of weeks to 'bed in', this briefing note provides an initial overview of what Investment Pathways are and how they work, before addressing their implications for both consumers and advisers.

Overview

Q What are 'Investment Pathways'?

A. With effect from 1 February 2021, consumers with DC pensions who choose to take retirement income through Flexi-Access Drawdown (FAD) rather than via an annuity, without firstly obtaining regulated financial advice, will be offered a range of Investment Pathways from their pension provider (unless that provider is a 'pathway investment exempt firm' – see below). These 'non-advised' consumers will be asked by their provider to select which one, out of four retirement scenarios, most closely reflects their plans on utilising their FAD fund over the next five years.

Their pension provider must make available a range of four Investment Pathways, and the underlying 'Pathway Investments', designed to be broadly appropriate for these four scenarios (see below).

The consumer then chooses whether to select one of the Pathways, or to select from the wider range of investment funds available via their pension provider.

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What are the four retirement scenarios?

A. The four scenarios to choose from are as follows;

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

What's the difference between 'Investment Pathways' and 'Pathway Investments'?

A. Although they sound very similar, the two phrases - as defined by the FCA – are not interchangeable;

- 'Investment Pathways' refers to the FAD investment selection journey, including the four scenarios above, that the pension provider must present to their customers; whilst
- A 'Pathway Investment' is the underlying investment solution in which a customer's DC pension fund will be invested.

What is a 'pathway investment exempt firm'?

A. It's a pension provider that has either elected not to offer Pathway Investments, or is satisfied that fewer than 500 of its non-advised clients will designate funds into FAD during the next twelve months. After twelve months that decision must be reviewed and, if the outcome of that review indicates that the provider will no longer meet the criteria for the exemption, they will then have up to twelve months from the review date to implement pathway investments.

What led to the FCA mandating the use of Investment Pathways?

A. The Government's 2015 'pension freedoms' gave consumers more flexibility in how and when they could access their DC pension savings, but they also added another layer of consideration when it came to selecting pension investments.

The FCA's "Retirement Outcomes Review" highlighted their concern that many consumers could deprive themselves of future retirement income, as a result of poor investment decisions with their pension fund.

For example, one study found that over 40 per cent of savers who went into drawdown to access their tax-free cash sum left their remaining pot untouched, whilst the FCA's own research revealed that 33 per cent of non-advised consumers had their entire pension fund held in cash, as well as 18 per cent of non-advised SIPP consumers.

As a result, the FCA published consultation papers in 2018 and 2019, which proposed that pension providers offer non-advised customers a range of investment solutions that broadly meet their retirement objectives, to be known as "Investment Pathways".

It also proposed that consumers' pension investments are not automatically defaulted into cash at the point of accessing their fund, unless the customer actively chooses this option, whilst estimating that these changes could benefit people by up to £25m a year.

Q Why has Flexi-Access Drawdown become so popular since the 'pension freedoms' began?

A. Prior to April 2015 when the 'pension freedoms' were introduced, the most common approach for turning a pension fund into retirement income was to purchase an annuity, which provided a known, guaranteed income for life. However, very low interest rates over the last decade have meant that annuity rates have also been at an all-time low, increasing their perception as offering poor value for money.

Recent FCA statistics show that Flexi-Access Drawdown is now three times as popular as buying an annuity. Rather than handing their pension fund to an annuity provider to purchase a guaranteed income for life from them, consumers can keep their pension funds invested whilst 'drawing down' an income that can be varied at any time.

Historically, drawdown was utilised by those with larger pension funds who opted for drawdown over other options, after receiving professional financial advice.

Since the 'pension freedoms' were introduced, however, the number of individuals going into drawdown with smaller funds and without the benefit of financial advice has soared. Because of the risks inherent within drawdown, when compared with the certainty of an annuity, the FCA have introduced Investment Pathways as a safeguard against an individual exhausting their DC pension fund too early.

Q Do only certain types of pension arrangements have to offer Investment Pathways?

A. No. Despite our reasoning within our response to the FCA's consultation papers that Investment Pathways were unlikely to be used by SIPP clients, typically with larger funds and a desire to make their own investment decisions, the FCA proposed a 'one size fits all' approach in their final Policy Statement in 2019 for all pension providers, regardless of the type of FCA-regulated pension arrangement(s) that they offered.

Implications for consumers

Just as we argued in our consultation responses that imposing Investment Pathways upon SIPP providers could create a 'white elephant', it could also be argued that the 'elephant in the room' arising from the potential consumer 'harms' that the 'Retirement Outcomes Review' uncovered, is for consumers to seek regulated financial advice before they go into drawdown with their pension fund. And yet the FCA are notably quiet on this seemingly 'obvious' solution.

> The reality is, however, that the pension freedoms put the decision-making firmly within the grasp of those individuals approaching age 55, whilst offering a free guidance session with "Pensions Wise" for all those aged over 50.

As a result, consumers are under no compulsion to seek professional financial advice, and many may not be prepared to pay for it, if they can achieve their objective of accessing their pension fund without it.

Against this backdrop, what will Investment Pathways do for consumers?

Some consumers approaching retirement may never have had to make an active investment decision with their pension fund. For example, those individuals who have been automatically enrolled into a workplace pension scheme are typically invested in a 'default fund' where third parties make all the investment decisions for them.

The FCA is concerned that consumers who don't seek regulated financial advice could make inappropriate investment choices for their needs, circumstances and objectives, involving either too much or too little investment risk.

The aim behind the Investment Pathways being linked to four retirement scenarios, therefore, and supported by guidance offered by pension providers and/or Pensions Wise, is to seek to reduce the number of consumers who make inappropriate investment choices for their retirement planning.

Just as importantly, however, is what Investment Pathways won't do for consumers.

Drawdown undoubtedly offers consumers significant flexibility to achieve ongoing investment growth of their pension fund, whilst allowing them to choose how much income to take from their fund and when, in response to changes in their circumstances during retirement.

> Comparing this to the guaranteed income for life offered by an annuity, however, where the pension fund and the associated investment risk is irrevocably handed over to an annuity provider, drawdown comes with far greater personal responsibility and risk.

In drawdown, decisions have to be taken regarding not just where to invest but also how much income to take out, and both these decisions should be reviewed regularly. As many non-advised consumers will be relying on their drawdown fund to provide them with an income throughout their retirement, taking out too much income too early whilst investing the fund inappropriately, could mean that their fund will run out before they die.

Allied to this is the fact that none of us know exactly how long we will live for.

In contrast to seeking regulated financial advice, Investment Pathways will not offer a consumer any help in deciding how much income to take, nor how frequently to take it. Investment Pathways do not allow for an individual's personal circumstances, attitude to investment risk, or capacity for loss. Finally, no adviser recommendation is provided, outlining which of the four pathways is the most suitable one for them – and why.

Implications for advisers

So far, the focus of this briefing note has been on consumers who have either chosen not to undertake financial advice for their retirement planning, and/or who may not be able to afford regulated financial advice, and the FCA-mandated 'solution' of Investment Pathways to minimise the risk of non-advised consumers making inappropriate investment decisions with their drawdown pension fund.

Of those pension providers who have offered Investment Pathways from 1 February 2021, the underlying 'Pathway Investment' for each pathway is typically a single multi-asset fund comprised of low-cost 'index-tracking' and/or 'target date' funds.

The inference of this for financial advisers is that Investment Pathways is an FCA-led market intervention aimed at non-advised consumers and, therefore, requires little or no involvement for them.

However, the reality is that Investment Pathways do have some important implications for adviser firms.

Firstly, pension providers must offer these pathway options to both advised and non-advised customers alike, meaning that advised clients will be aware of their existence (and may even express an interest in them).

Secondly, and arguably more importantly, the non-advised Pathway Investments - and their underlying low-cost charging structure - may well become a 'benchmark', against which regulated financial advice is both compared and measured.

Thirdly, when advising their clients about drawdown investments, advisers will have to include a consideration of Pathway Investments within their advice and recommendations.

> This means that the adviser will have to explain why their recommended investment-based solution is more appropriate than the Pathway Investment fund that the client could have selected.

In addition, if the adviser has not provided the client with a personal recommendation to transact a move into drawdown within the last twelve months, the client must be taken through the Investment Pathway process.

As a result, advisers may find themselves under increased scrutiny to demonstrate the value of what they provide, in comparison to what an individual can receive directly from their pension provider.

This also carries with it the risk – and it is something that we highlighted in our consultation responses – that consumers may perceive the choice of Investment Pathways and Pathway Investments offered by their pension provider as constituting 'advice'. This is an aspect that needs to be closely monitored by the FCA.

That said, the introduction of Investment Pathways does provide advisers with an opportunity to demonstrate the quality of their regulated financial advice to an individual about to draw income from their pension fund(s). This compares with the fact that Investment Pathways are unlikely to properly assess a consumer's attitude to investment risk and capacity for loss, as well as the imperfect nature of Investment Pathways themselves.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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