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Choice and flexibility: Optimising decisions at retirement

Rationale for Retirement Behaviour Working Party

Leeds
November 2015

Agenda

- Background & Challenges
- A Retirement Game
- Discussion & Feedback

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The new retirement landscape

“the biggest change to UK pensions in almost a century”- George Osborne

Recap

- Prior to April 2015, DC pots in the UK, in general, had to be used to buy an annuity at retirement. Individuals had the relatively simple choices of:
  - When to convert their pot
  - How much tax free cash to take
  - What type of annuity to buy (fixed/index linked, single/joint life etc)
- From April 2015, there is no longer a requirement to buy an annuity, individuals can now:
  - Cash in 100% of their pension pot (25% tax free);
  - Drawdown from their pension pots;
  - Purchase an annuity; or
  - Combination of drawdown and annuitising.

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The new retirement landscape

Lots of risks

Actuarial risks

Mortality and longevity risk

Inflation

Investment

Model risk

Data risk

External risks

Mis-selling and fraud

Legislation changes, eg tax or pension changes

Individual risks

Risk of poverty in retirement

Risk of leaving nothing to dependants

Regret risk

Poor decisions

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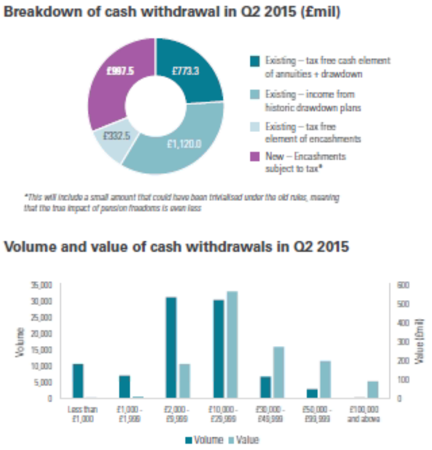
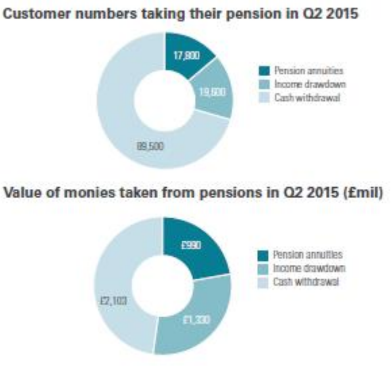
The new retirement landscape
2015Q2 customer behaviours

Initial ‘dash for cash’ has reduced, but too early to define ‘new normal’





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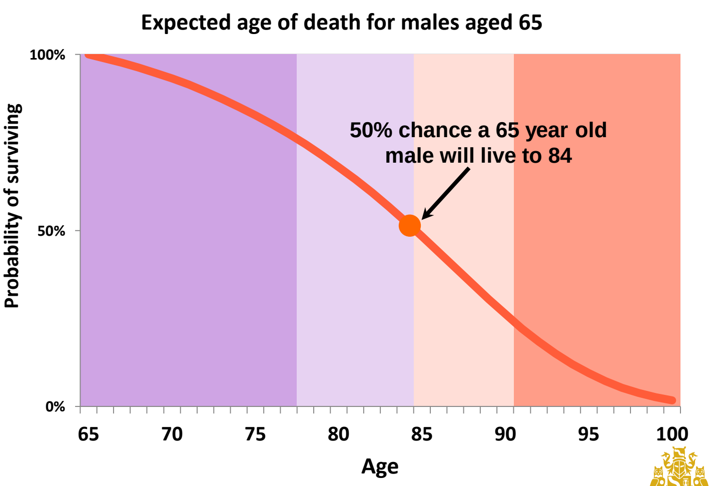
Source: ABI & KPMG, September 2015

The new retirement landscape
People don’t die on time



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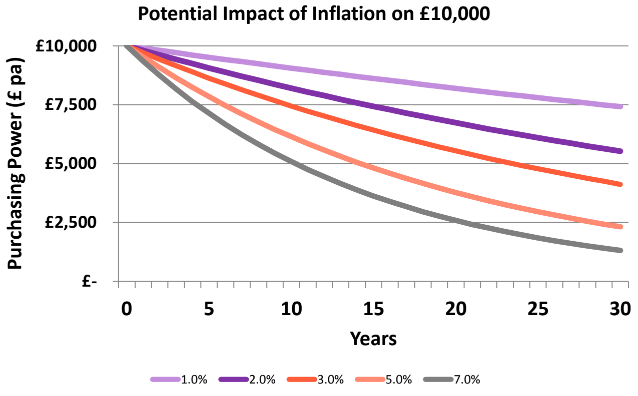
Significant variability in survival ages

SOURCE: **ONS LIFE TABLES 2010-12**

The new retirement landscape
Inflation can significantly erode your spending power…



Even at 2% pa, could lose 1/3 of spending power in 20 years

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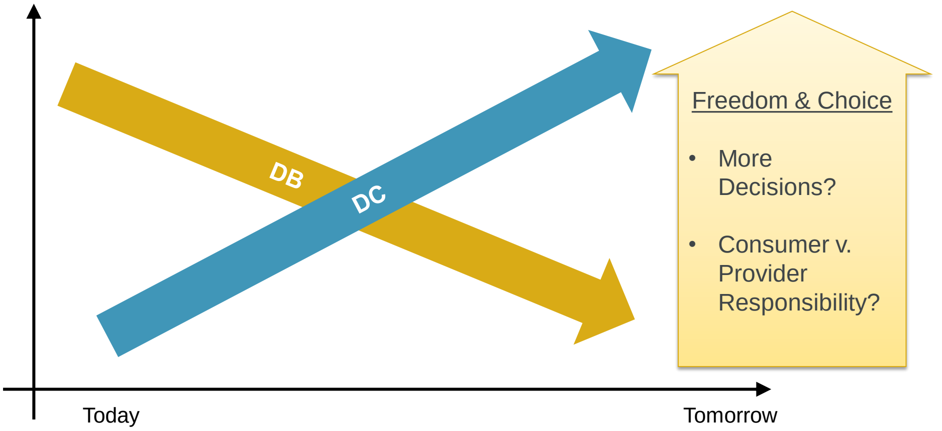
More decisions…
A ticking time bomb?



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A retirement game

"Life is more fun if you play games" - Roald Dahl

Working Party aims

- Target those with no access to financial advice
- Build a game – 'education through gamification'
- Developments – address biases / PensionWise / App ?

Background

- 300,000 people pa will be choosing what to do with their pension pots – could be biggest financial decision of their lives.
- Game is still relatively complex for end consumers, but still massively simplifies at-retirement decision making.
- Many people likely to make sub-optimal decisions largely due to behavioural biases.

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A retirement game
Your brief

- You are advising* an individual, Jo, on retirement decisions
- Age 65, single with no dependants and a DC fund of £100,000 (after taking and spending tax-free cash)
- Jo wants *"to beat an annuity"*

How you play the game

- Advise on two things:

1. How much should Jo take as income or annuity over the next 10 years?
2. How should Jo invest the balance?

- You revisit your advice every 10 years

** Assume you are suitable qualified and regulated to do so*

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A retirement game
Results

<u>Some Key Points</u>

- It's not possible to seek optimal solutions (don't know when you're going to die)…BUT…
- …can we help people to avoid the worst decisions?
- People are likely to under-estimate their life expectancy and / or be inclined to "live for today"
- Decision-making is iterative not one-off
- Possible side-effect is that people will realise they cant afford to retire yet!

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Impact of behavioural economics?

Our **preferences** are influenced by emotions and psychological experiences	Rules of thumb can lead to incorrect **beliefs**	We use **decision-making** short-cuts when assessing available information
Present bias e.g. spending on a credit card for immediate gratification ***Reference dependence and loss aversion*** e.g. believing that insurance added on to a base product is cheap because the base price is much higher ***Regret and other emotions*** e.g. buying insurance for peace of mind	***Overconfidence*** e.g. excessive belief in one's ability to pick winning stocks ***Over-extrapolation*** e.g. extrapolating from just a few years of investment returns to the future ***Projection bias*** e.g. taking out a payday loan without considering payment difficulties that may arise in the future	***Framing, salience and limited attention*** e.g. overestimating the value of a packaged bank account because it is presented in a particularly attractive way ***Mental accounting and narrow framing*** e.g. investment decisions may be made asset-by-asset rather than considering the whole investment portfolio ***Decision-making rules of thumb*** e.g. investment may be split equally across all the funds in a pension scheme, rather than making a careful allocation decision ***Persuasion and social influence*** e.g. following financial advice because an adviser is likeable

Source: Applying behavioural economics at the Financial Conduct Authority, FCA April 2013

Discussion
Working Party next steps

We welcome your input!

- Seek behavioural economics expertise
  - how to "frame" the game
  - research with live users to test decision-making biases and refine the game
- Liaison with interested parties (eg PensionWise, Citizens Advice, MAS, FCA, etc)
- Formal IFoA sign-off
- "Launch" (Web / App, etc)

Vision: help public make better / informed retirement choices
Focus on non advised customers with DC pots of say £50-250k

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