Institute and Faculty of Actuaries

Pensions Conference 2015

24 – 26 June
Hilton Hotel, Glasgow

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Choice and flexibility: Optimising decisions at retirement

Rationale for Retirement Behaviour Working Party

Glasgow
25 June 2015

Agenda

- The New Retirement Landscape
- A Retirement Game
- Discussion

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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
  - a 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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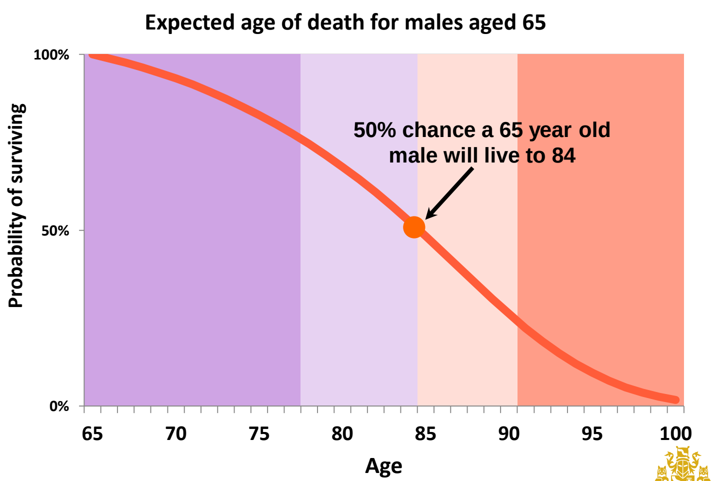
The new retirement landscape
People don’t die on time



Significant variability in survival ages

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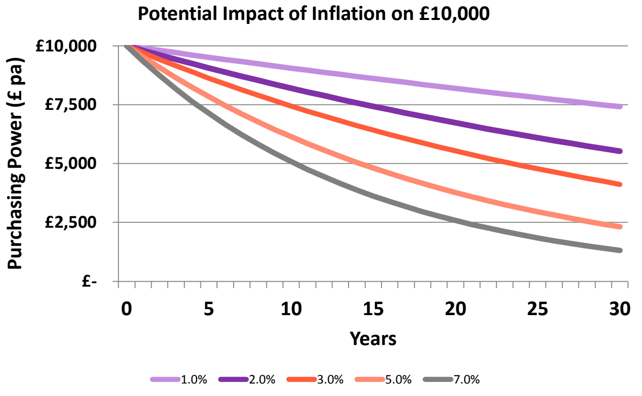
SOURCE: **ONS LIFE TABLES 2010-12**

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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Let's play a game

A retirement game
“Life is more fun if you play games” - Roald Dahl

Working Party aims
- Target those that need help / no access to financial advice
- Build a game – “learn through experience”
- Developments – address biases / PensionWise / App / product development?

Background
- 300,000 people pa will be choosing what to do with their pension pots – could be biggest financial decision of their lives.
- Game taken months to build and uses complex modelling, but still massively simplifies at-retirement decision making.
- For example they will need to allow for tax free cash, dependants, debt, salesmen etc and they will be facing a choice between thousands of investment options.
- Unfortunately, many of these people will 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 of £33,333)
- Jo wants *“to consume as much as possible of my fund before I die subject always to having at least £3,000 annual income to supplement my State pension.”*

How you play the game

- Advise on two things

1. How much income should Jo take over the next 5 years?
2. Where should Jo invest the balance?

- You revisit your advice every 5 years

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

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A retirement game
Results

Decisions
- Number increased
- Iterative rather than one-off

Some choices will limit future choices
- How much choice is too much choice?

Not clear what best decision is
- All decisions can be sub optimal as only really know best decisions after death!

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Discussion

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
Behavioural Bias

- Present Bias
- Herd Mentality
- Framing

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