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Choice and flexibility: Optimising decisions at retirement

Rationale for Retirement Behaviour
Working Party

London
12 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

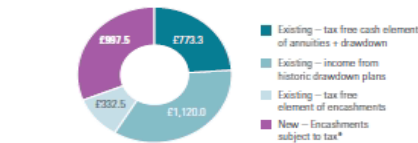Regret risk

Poor decisions

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The new retirement landscape
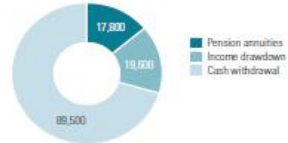### 2015Q2 customer behaviours

Initial 'dash for cash' has reduced, but too early to define 'new normal'
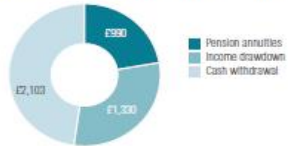
Breakdown of cash withdrawal in Q2 2015 (£mil)

£997.5 | £773.3 | £332.5 | £1,120.0

- Existing – tax free cash element of annuities + drawdown
- Existing – income from historic drawdown plans
- Existing – tax free element of encashments
- New – Encashments subject to tax*

*This will include a small amount that could have been trivialised under the old rules, meaning that the true impact of pension freedoms is even less

Volume and value of cash withdrawals in Q2 2015

■ Volume ■ Value

Customer numbers taking their pension in Q2 2015

17,800 | 19,600 | 89,500

- Pension annuities
- Income drawdown
- Cash withdrawal

Value of monies taken from pensions in Q2 2015 (£mil)

£990 | £1,300 | £2,100

- Pension annuities
- Income drawdown
- Cash withdrawal

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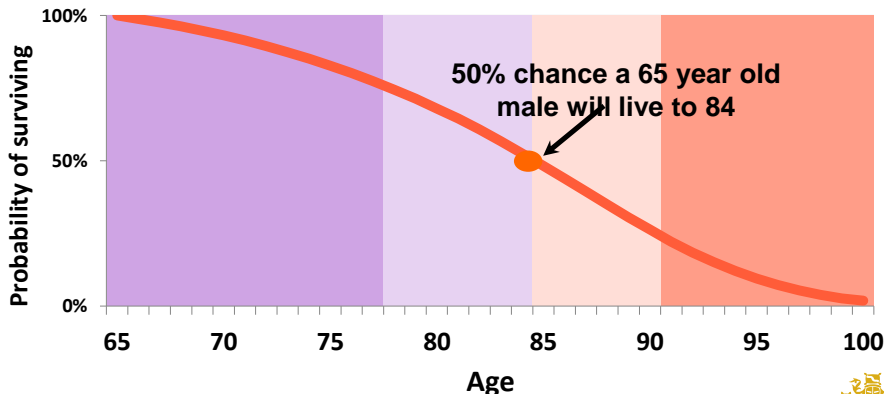
Source: ABI & KPMG, September 2015

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The new retirement landscape
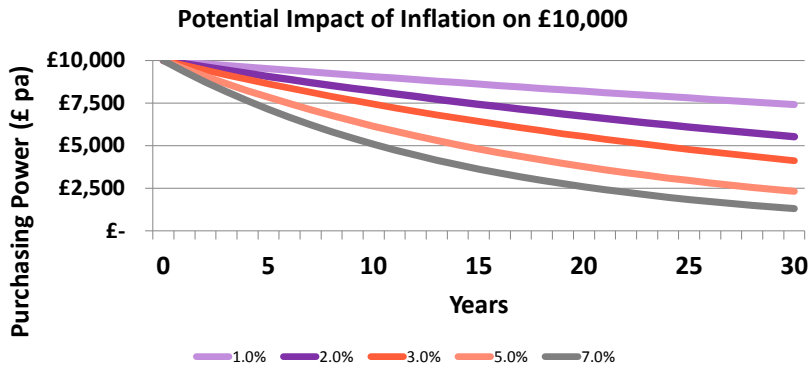### People don't die on time

Expected age of death for males aged 65

50% chance a 65 year old male will live to 84

Significant variability in survival ages

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

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

Potential Impact of Inflation on £10,000

Purchasing Power (£ pa)

£10,000
£7,500
£5,000
£2,500
£-

0   5   10   15   20   25   30

Years

—— 1.0%   —— 2.0%   —— 3.0%   —— 5.0%   —— 7.0%

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

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More decisions…
A ticking time bomb?

DB

DC

Freedom & Choice

• More Decisions?

• Consumer v. Provider Responsibility?

Today   Tomorrow

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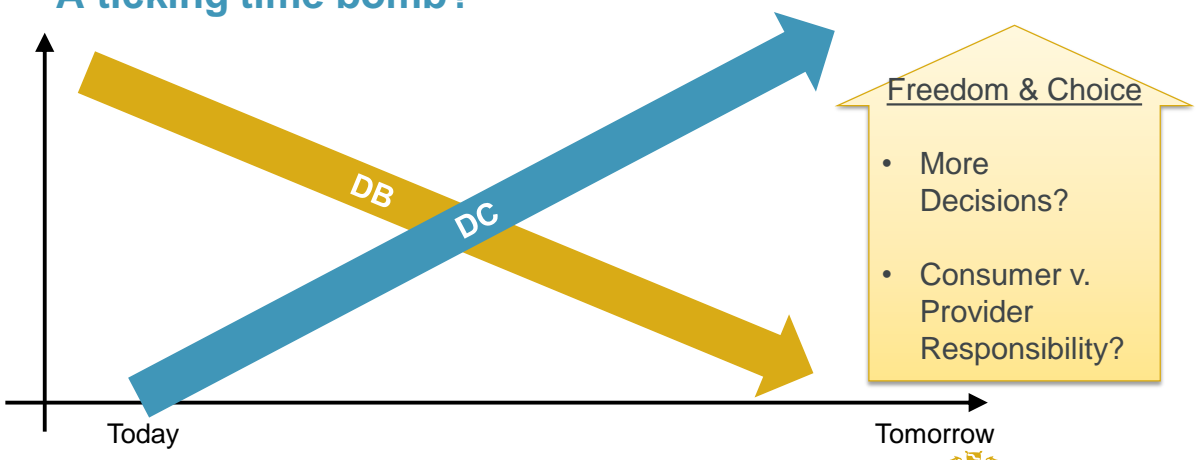
Let's play a game

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

Working Party aims
- Target those 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.

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

Some Key Points

- 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

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

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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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