What should consumers do with their retirement savings?

Turning Savings into Retirement Income Working Party Update

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Agenda

- Overview of the New Retirement Landscape
- Retirement Options
- Initial Results
- Summary & Discussion

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Working Party Background

IFoA set up a working party to investigate:

- How much income individuals could receive through retirement given different retirement income decisions?
- Is it possible to devise some useful rules of thumb for non-advised consumers at / during their retirement journey?

We would like to share progress to date and gather your feedback

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New Retirement Landscape

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New Retirement Landscape

- Significantly increased media coverage of retirement options
- George Osborne: “no one will have to buy an annuity”
- Drawdown available without an adviser
- Pensions Wise launched (but low take up)

➢ **How do consumers decide what to do?**

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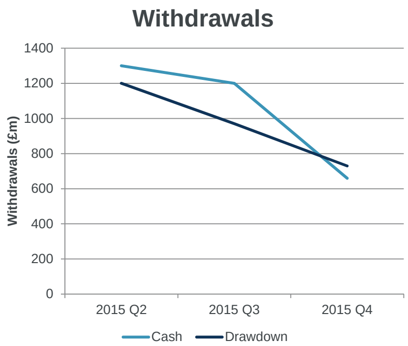
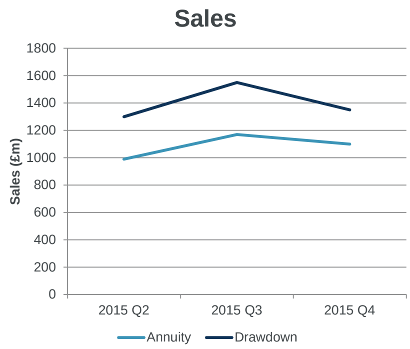
AF1

2015 Experience post F&C changes





- Sharp reduction in withdrawals
- Small pots being withdrawn as cash
- Larger pots generally using drawdown

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Source: ABI, ‘One Year On’

Slide 6

AF1 I don't have an specific objections to this slide, but I'm a bit unclear about the message that it is intended to convey.

Alec Findlater, 16/05/2016

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Retirement Options

Annuity v. Drawdown

Annuity (standard)

✓ Guaranteed Income

✓ Easier to understand

✓ Higher income possible

x No death benefit in later years

x No (current) ability to change initial decision

x Expensive for inflation-linked?

Drawdown

✓ Flexibility for income

✓ Death benefits

✓ Tax efficient investment growth

✓ Can buy annuity later or not

x Income isn't guaranteed

x Significant investment and longevity risks

x Complicated to understand, manage and more expensive

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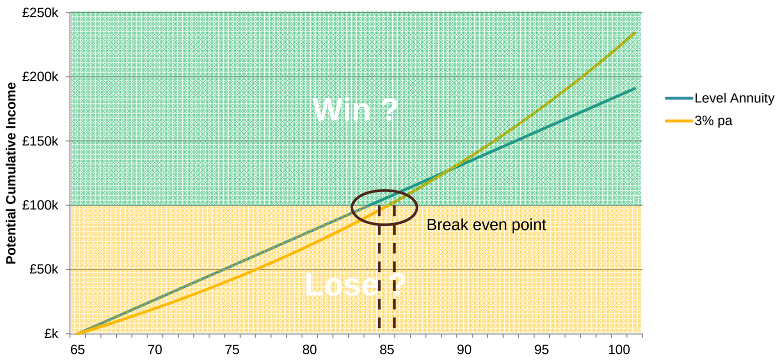
Annuities – when do customers win?



- Takes 19-20 years for customers to get their money back (ignoring inflation)
- Takes 24 years for 3% escalation to beat level annuity

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Assumes competitive single life annuity rates of 5.3% level and 3.7% for 3% escalation on a £100k pot and no TFC

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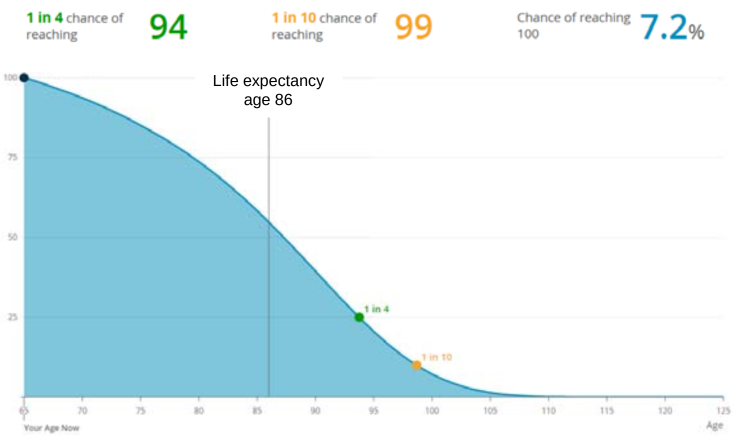
Life expectancy – significant variability



- ➢ Individuals could be at risk if focus on average

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Source: ONS, http://visual.ons.gov.uk/how-long-will-my-pension-need-to-last/

Example shown is 65 year old male

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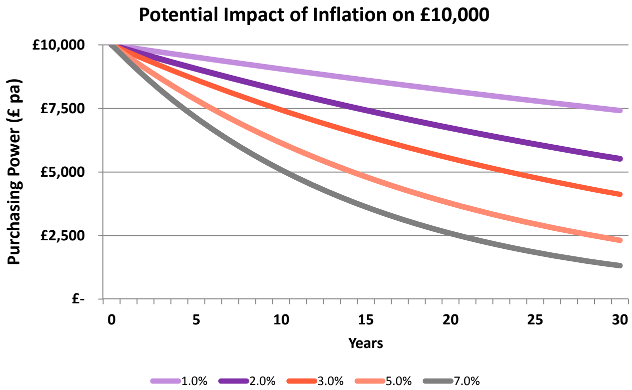
Inflation can significantly erode your spending power…



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

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How to value choices and strategies?

- Many possible approaches, but we have initially focused on percentiles, fund values and points of ruin
- Customer approach of measuring value could be very different…
  - Joe and Simon are two friends who both started in drawdown…
  - After five years, Joe decided to annuitise his remaining pot having seen annuity rates rise and not wanting to take the investment risks anymore. Simon decided to stay in drawdown because he felt his fund had grown well so far.
  - Even if Joe dies at an average age and Simon has average fund growth, who has done best?
  - How differently do customers value certainty / insurance v. flexibility?
- Disconnect between customer pension decisions and value?

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Initial Results

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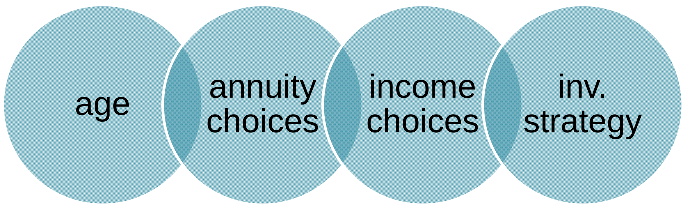
Modelling Approach



Used stochastic model to test combinations of:

- Varying income levels taken from drawdown
- Combinations of level and inflation-linked annuities and drawdown
- 5 risk graded investment strategies

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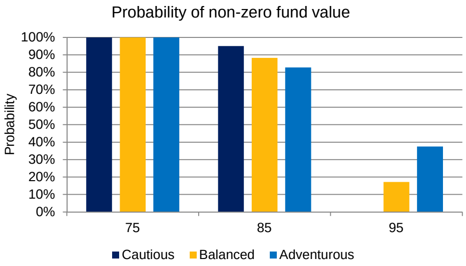
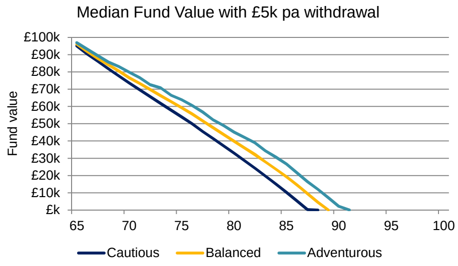
Result 1a – 'level annuity' income in drawdown…

- If take 5% income in drawdown….





- Cautious strategies increase certainty…
- …but reduce income / upside in later years

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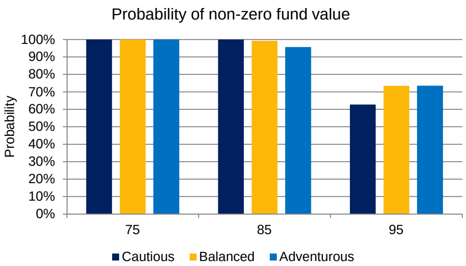
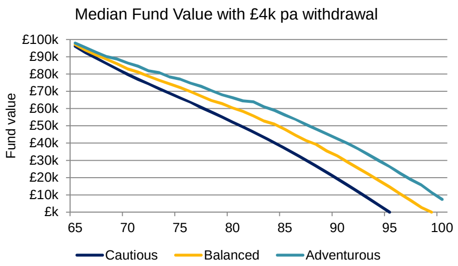
Assumptions: 65 year old, £100k pot, 1% AMC total charge

Result 1b – sub annuity income in drawdown…

- If take 4% income in drawdown….





- 4% income rate is more certain of providing better outcomes at later ages
- Currently about half way between level and IL annuity rates

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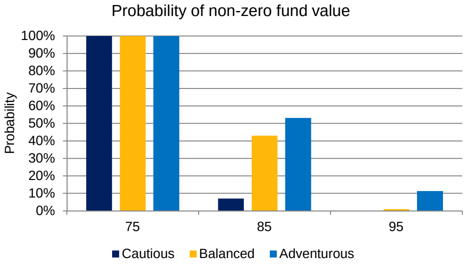
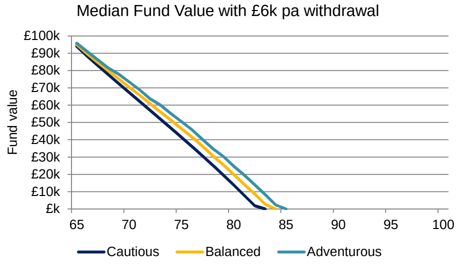
Assumptions: 65 year old, £100k pot, 1% AMC total charge

Result 1c – higher income in drawdown…

- If take 6% income in drawdown….





- 6% income rate provides higher income than annuity initially but likely to run out much sooner (about 5 years sooner than 5% rate)
- Risk running out of money by age 85 with ~70% probability

Assumptions: 65 year old, £100k pot, 1% AMC total charge

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Results 1 – Learning Points

<u>Varying drawdown income levels</u>…

- Customer income choices have significant impact on when they will run out of money
- Customer income level choice appears more important than investment strategy choice
- Setting drawdown income level to level annuity rate risks ruin by age 90

> **Suggests sustainable income rate could be 4%**
>
> **ie sub level annuity rate given no pooling effect**

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Result 2 – Drawdown, then annuity…

What happens if use drawdown and then annuitise later?

- Provides flexibility in early years if circumstances change
- Avoid buying an annuity in early years when mortality drag is lower
- If buying IL annuity then buying inflation protection for shorter period
- How to value (or not) death benefits?

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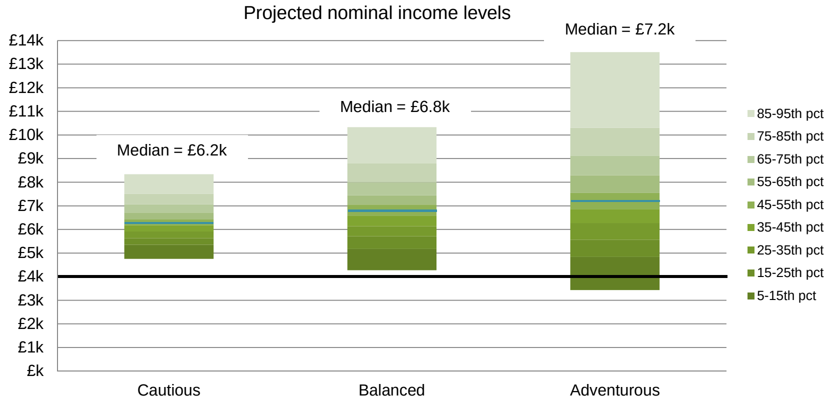
Result 2a – £4k drawdown, then level annuity…



- Lower initial income can significantly improve annuity income
- Riskier investment strategy increases range of outcomes

Assumptions: 65 year old, £100k pot, £4k income for 10 years then level annuity purchase, 1% AMC total charge

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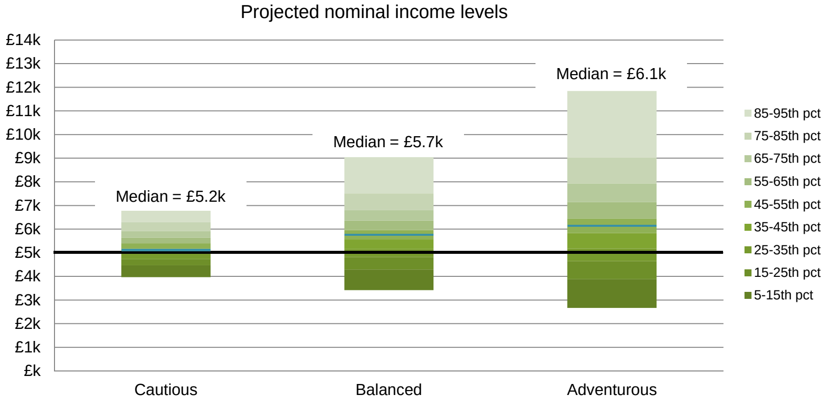
Result 2b – £5k drawdown, then level annuity…



- Median results suggest can get same or better income
- But significant variability: 30-50% chance could get less

Assumptions: 65 year old, £100k pot, £5k income for 10 years then level annuity purchase, 1% AMC total charge

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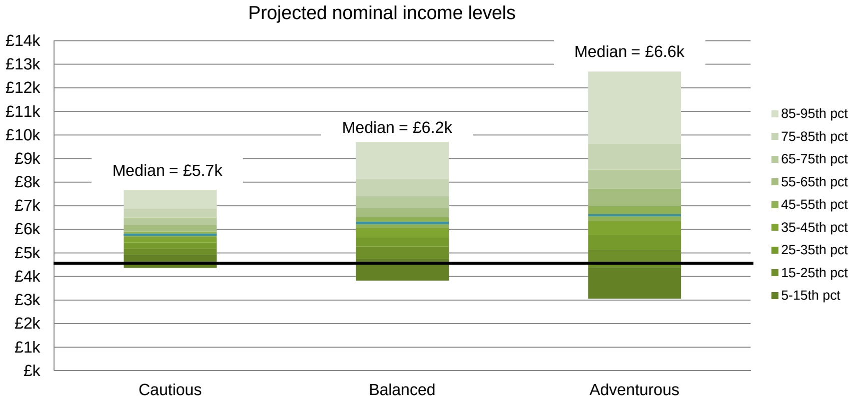
Result 2c – £4.5k drawdown, then level annuity…



- ‘Mid’ income rate suggests 80-90% chance that annuity income could be same or better (depending on investment strategy)

Assumptions: 65 year old, £100k pot, £4.5k income for 10 years then level annuity purchase, 1% AMC total charge

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Results 2 – Learning Points

Deferred annuity purchase…

- Initial income choice has significant impact on outcomes
- Choosing a 'mid' 4.5% income level provides a good chance annuity income could be same or better
- Riskier investment strategies will introduce more variability to outcomes

> **➢ Best outcome depends on customer income needs?**
>
> **➢ Income now v. later?**

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Rule of thumb risks

Likely to need:

- Appropriate caveats (life expectancy?)
- Ongoing suitability review
- Revision if key factors change significantly, eg
  - Inflation rising
  - Annuity prices reduce
  - Longevity
  - Tax changes

- Rules of thumb are not appropriate when
  - Health changes
  - Change in some personal / family circumstances

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What are we going to do with this analysis?

- Plan to produce a policy paper based on this analysis to discuss and propose potential rules of thumb for drawdown and ages it may be better to annuitise
- Engage with external stakeholders on how the IFoA can help them to inform non-advised consumers

  (NEST, Money Advice Service, Citizens Advice Bureau and Pension Wise)
- Potentially issue a press release to promote the work of actuaries in the public interest

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Summary & Discussion

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Summary & Discussion

Customer decisions

- Number of decisions gone from 1 to x
- Optimal customer decisions may only known after death…but customers likely or want to value whilst alive!

Results

- Inflation linked annuities seem expensive as buying insurance from longevity and inflation
- To avoid running out of money, likely to need modest sustainable income rate in drawdown, eg 4%
- A combination of drawdown then annuity looks appealing
- But if knew were going to live a long time, annuity may be better?

➢ Generic rules of thumb tricky and depend on customer needs for flexibility v. certainty

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Questions?

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