Institute and Faculty of Actuaries

Investor Behaviour in the Freedom of Choice Pensions Market

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Contents

1. Executive summary

The changes in regulation with regard to pensions freedoms which came into force from April 2015 have increased the flexibility available to those in, at, or near retirement with regard to how they access these retirement savings. At the same time, the adoption of auto-enrolment has increased the number of those who will be making such decisions in the future.

The enthusiastic response to the pensions freedoms among investors has shown a clear demand amongst many to utilise this flexibility. Such decisions will be amongst the most important financial choices that many retirement savers will make during their lives. The increased flexibility has seen a marked increase in the number and type of products available with the aim of providing an income in retirement. How investors define their priorities and choose between these varied options is of interest to employers, product providers, financial advisors, regulators and government, amongst others.

This Working Party was established based on the belief that actuarial skills and analysis can improve understanding of the priorities, trade-offs, and decisions made by individuals and hence outcomes for people looking to convert retirement savings into a comfortable retirement. The scope of the Working Party covers areas such as:

- What are the key priorities for retirees, how do they evaluate trade-offs between them when making decisions?
- How these preferred outcomes and trade-offs differ for different subsets of retirees?
- What models can aid understanding of individuals when facing such choices?
- What form of product or what features of products, such as guarantees for example, are more likely to be successful in meeting these requirements?

This Review Paper reflects the findings of the Working Party to date in these areas, and sets out areas for further work. We discuss the response to the pensions freedoms over the period since April 2015, and how this has differed across different groups of savers. It is clear that income drawdown approaches, in particular, have replaced annuities as the retirement vehicle of choice for many with larger retirement savings pots; while a full cash withdrawal is often the favoured option for those accessing smaller amounts of savings.

We then explore some of the issues which have been thrown up by those taking advantage of the changes. The Paper discusses the uncertainty that changing spending requirements and life expectation creates around lifetime income planning for individuals. There is evidence that the lack of trust in financial institutions is influencing the decisions made around retirement savings. We also highlight the potential impact of behavioural factors as well as the lessening ability to make repeated complex decisions around the use of retirement savings in later life.

Unfortunately, there is little evidence that the pensions freedoms have led to increased engagement with long term pensions planning or sophistication in decision making from investors. This is less than optimal given the financial implications of such decisions and the wide range of factors which should be taken into account by each individual. The extra flexibility has seen a wide range of new or evolved products launched by both insurers and asset managers in light of the new freedoms, with investors able to choose between features such as income guarantees, death benefits or varying investment options. Indeed, a wide range of approaches are being taken to such drawdown decisions.

We note that the decisions on using retirement savings are not taken in isolation; other assets and sources of income available to the investor should also be taken into account. Given the complexity of the interactions it is surprising to the Working Party that formal financial advice is not taken more broadly, and again this is an area discussed in the Paper. We also note the recent consultation around the linked topic of developing default pathways in decumulation for auto-enrolment savers.

We introduce a possible aid in terms of decision making in the form of an 'Balance Sheet Approach'. This would combine assets/wealth, income and expected outgoings in a single, comprehensible form, while differentiating between the need for greater liquidity and certainty in the short term versus a necessarily less certain longer term.

We summarise the key findings of the Working Party in the penultimate section, before setting out next steps to build on the work and findings to date.

2. Acknowledgements

The authors would like to acknowledge and thank Martyn Fisher for his contribution to this research paper during his time as a member of the Investor Decision Making working party, 2016-2018.

3. Background & experience of pensions freedom of choice to date

3.1 What the 'pensions freedoms' changes mean

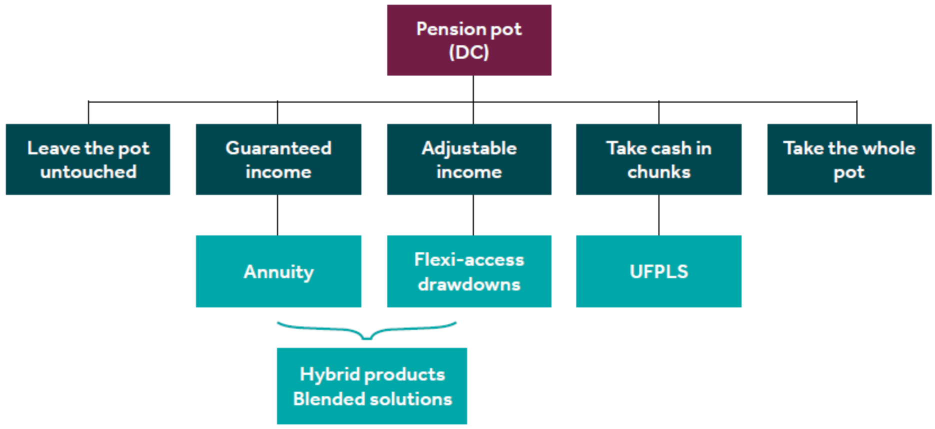
Up to April 2015, most Defined Contribution pension savers bought an annuity with their pensions pot. However, the government announced in 2014 that the regulations surrounding withdrawals from such a pot would be loosened, and these changes came into effect on 6 April 2015. The changes were focused at providing investors with greater flexibility to access their pension savings in later life.

Individuals enrolled in pension savings plans could now access their money in a wide range of ways. Ways in which the money can be accessed include withdrawing the full amount saved or smaller lump sums, taking regular drawdowns from the pot or purchasing an annuity.

Figure 1 shows the options available under the new freedoms in diagrammatic form. Between the two extreme options of leaving the pot untouched and taking the whole pot there are a variety of ways in which consumers may choose to access their funds. The conservative, but relatively inflexible, choice of taking a guaranteed income can be met by traditional annuity products. Greater flexibility enabling adjustable income can be obtained by the use of different types of drawdown products. These two approaches are not exclusive and consumers can find blended solutions to meet their own particular requirements by using hybrid products which combine annuities and drawdown products. Consumers wishing to have the greatest flexibility can simply withdraw cash as lump sums from their pot (Uncrystallised funds pension lump sums abbreviated to UFPLS) as desired subject to appropriate tax. The latter approach does not necessitate the use of products from the financial services industry.

Figure 1: Options to access pensions savings post pensions freedoms

Figure 11: Main options for how consumers, from the age of 55, can accesss their pension savings after the pension freedoms, April 2015



Source: FCA.

Note: Take cash in chunks refers to consumers who remain in accumulation and choose to crystallise chunks of their pension pot.

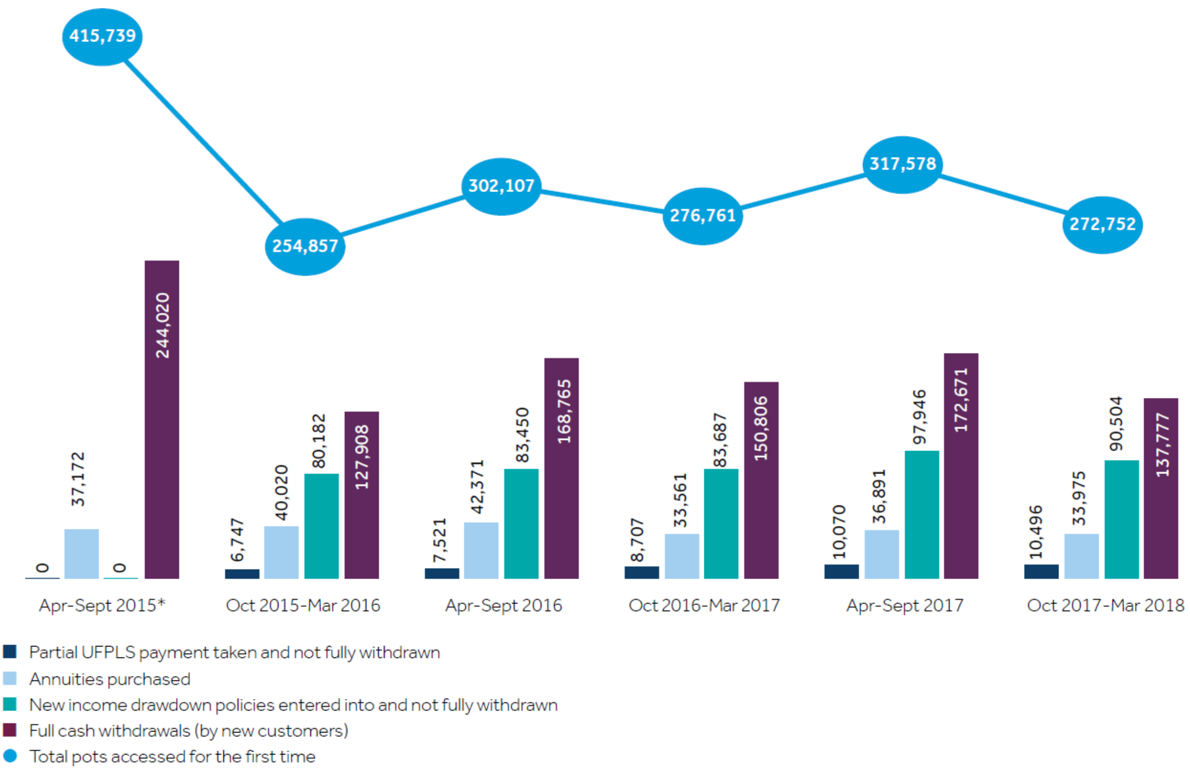
The tax treatment of the options outlined in Figure 1 varies, but in general 25% of the savings can be taken tax-free. There are potentially tax pitfalls for the uninformed consumer; for example, taking the proceeds of the pot in large lump sums can result in a much higher tax liability than a more measured approach.

3.2 Experience since 'pensions freedoms' were introduced

The reaction to the increased freedoms was initially very enthusiastic. This led to a high number of withdrawals from pension savings with over 400,000 pots being accessed for the first time in the period from April to September 2015, as shown in Figure 2. In subsequently quarters, however, the rate at which pots are accessed has stabilized at lower levels in the region of 300,000 per quarter.

Figure 2: Retirement income sales by product type since April 2015

Figure 2a: Retirement income sales by product type since April 2015 (number of pots accessed)

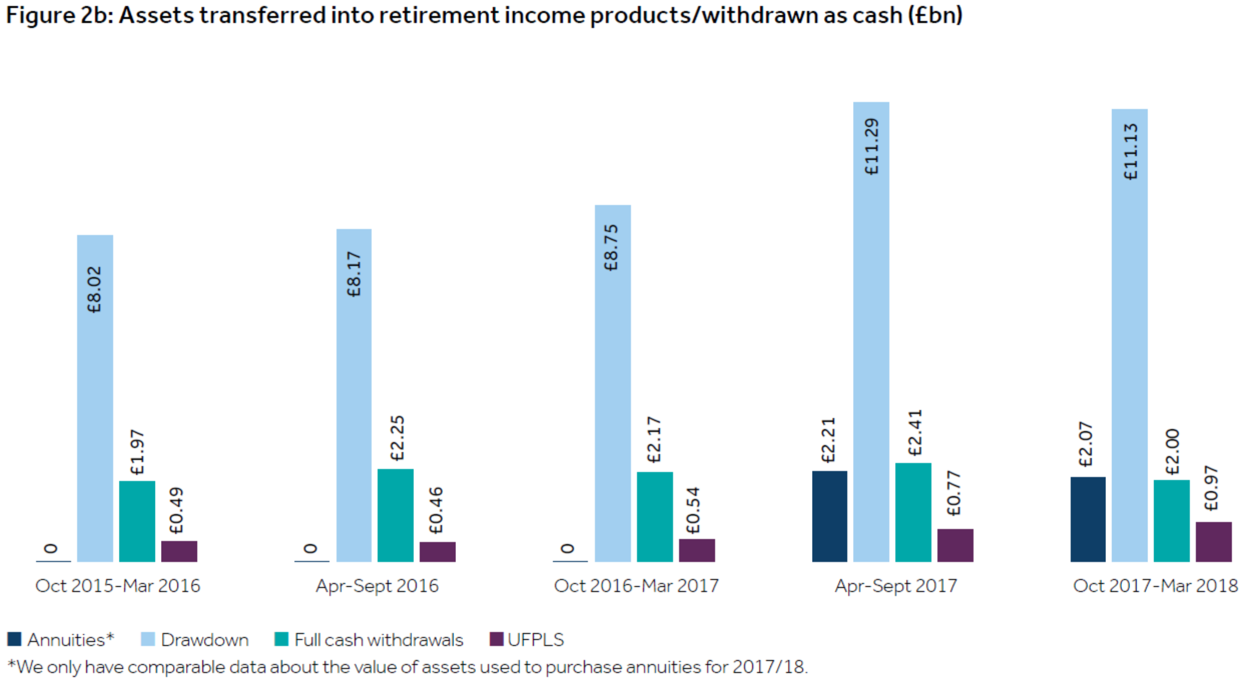


*Figures on drawdown and UFPLS were not collected in the same format between July and September 2015 and therefore have been omitted for this period.

Source: FCA Data Bulletin Issue 14, September 2018.

Full cash withdrawals, where people withdraw their entire pot, have generally accounted for half or more of pots accessed. Of the remainder, sales of drawdown products have generally been increasing and were over twice that of annuities in recent periods. The FCA's Retirement Outcomes Review found that over half of pots fully withdrawn were invested elsewhere. This is in contrast to some alarmist predictions made before the new freedoms that the money withdrawn would tend to be quickly spent on consumer goods and services.

Figure 3: Use of retirement savings accessed since October 2015

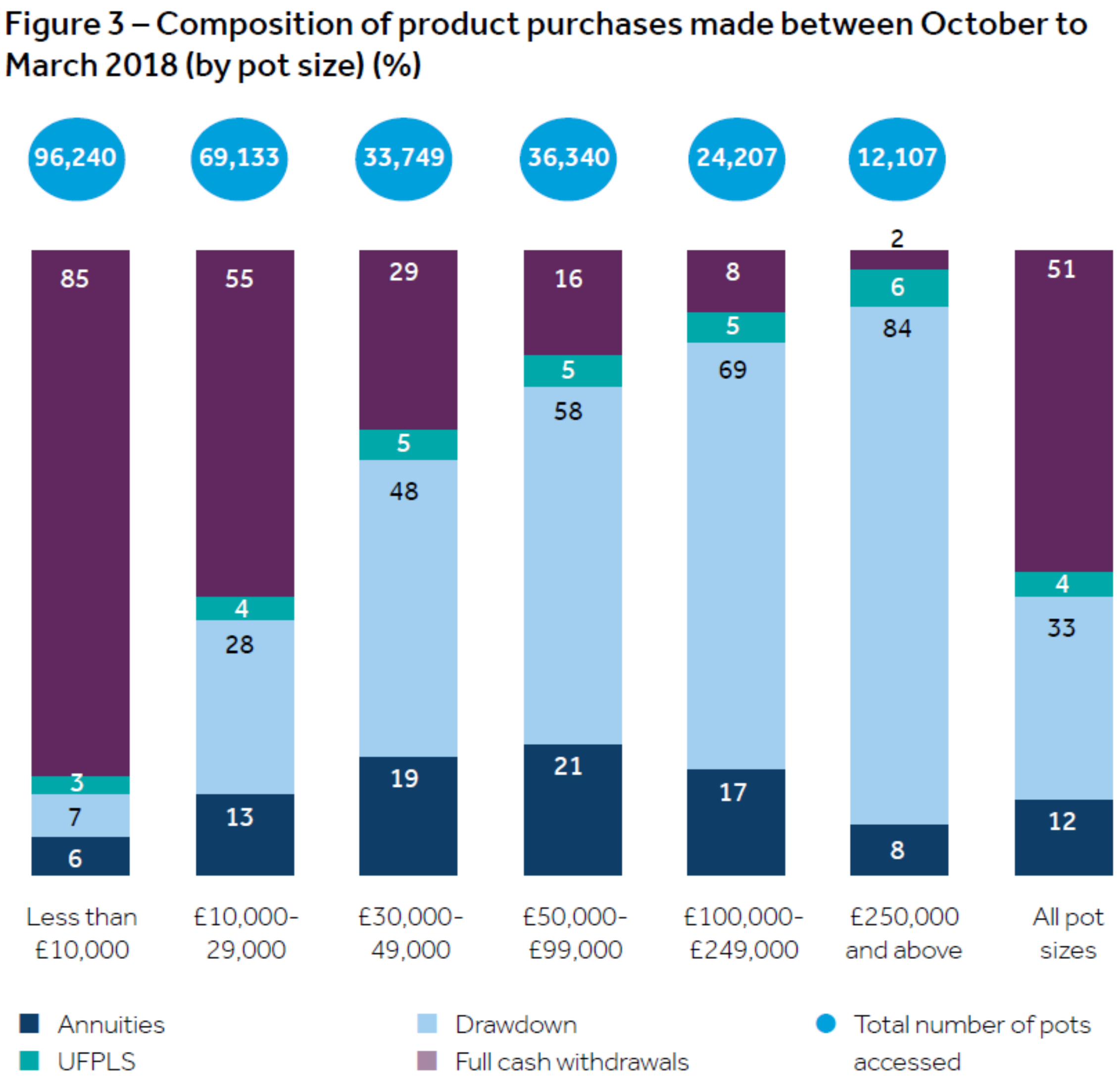


Source: FCA Data Bulletin Issue 14, September 2018.

When the data is reviewed by the total value of assets in pots which were accessed it is clear that drawdown products have proven most popular in attracting assets as shown in Figure 3. The amount of money put into drawdown products is of the order of five times greater than that going into annuities showing the limited attractions of the traditional guaranteed income model. Full cash withdrawals are of similar magnitude to annuity purchases while UFPLS withdrawals are substantially smaller. Overall, this shows quite a conservative attitude to accessing the assets.

The experience of investors has been subject to considerable variation, with the size of pension pot accessed a key differentiator as shown in Figure 4. The figures show that holders of smaller pots who accessed savings were much more likely to opt for a full cash withdrawal with 85% of people accessing pots of under £10,000 taking this approach. The proportion of people taking full cash withdrawals falls steeply with pot size to only 2% of people with pots of over £250,000. These findings seems to indicate a degree of rationality amongst investors with tax implications making the full withdrawal of large pots less attractive and policy charges mitigating against the use of drawdown for small pots. Drawdown gets progressively more popular as pot size increases with 84% of the investors with a pot size of over £250,000 using drawdown. Drawdown is the preferred decision for pots accessed of in excess of £30,000. Pots between £30,000 and £250,000 in value are the most likely to be used to purchase annuities although, even in this band, annuities are only used by around a fifth of individuals. UFPLS are relatively little used across the whole range of pot sizes with only in the region of 4% of investors using this approach. With the advent of the pension freedoms the use of annuities has substantially declined with only 12% of all investors using the product.

Figure 4: Composition of product purchases by pot size

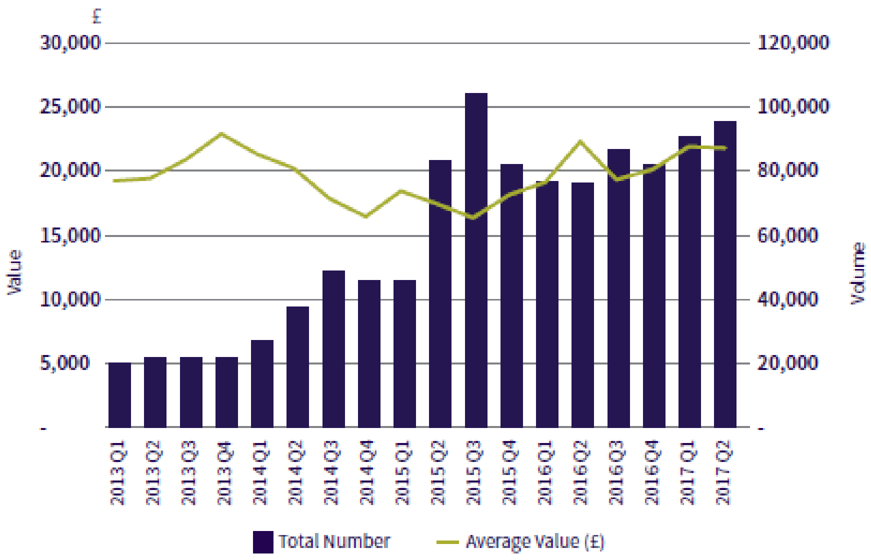


Source: FCA Data Bulletin Issue 14, September 2018.

The fall-off in annuity sales has been matched by a dramatic increase in the sales of income drawdown products, as shown in Figure 5. These accounted for a small proportion of the retirement income market before the pensions freedoms, but the number of sales have exploded in the period since with the number sold increasing from about 20,000 per quarter in 2013 to approaching 100,000 per quarter in the second quarter of 2017. In contrast, the average value of drawdown sales has remained fairly static at about £20,000 over the same period.

Figure 5: Volume and £ value of income drawdown products

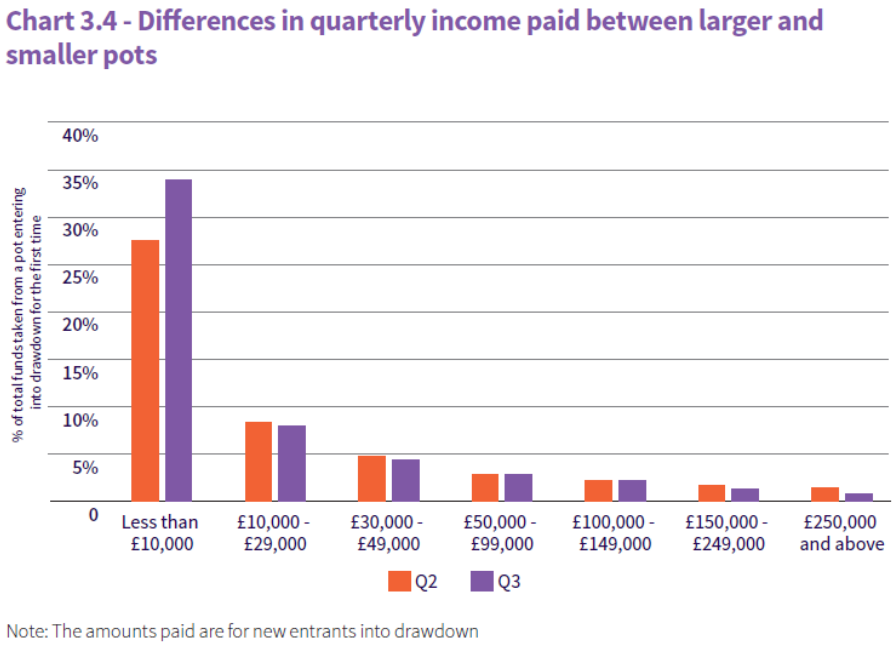
Figure 69: Volume and value (£) of income drawdown sales per quarter (2013Q1 - 2017Q2)



Source: ABI, UK Insurance and Long-Term Savings – The state of the market

Figure 6 shows the percentage of total funds taken from a pot entering into drawdown for the first time. It shows a declining percentage as pot size increases with figures in the region of 30% for small pots of under £10,000 declining to well under 5% for the larger pot sizes.

Figure 6: Differences in quarterly income paid between different size pots

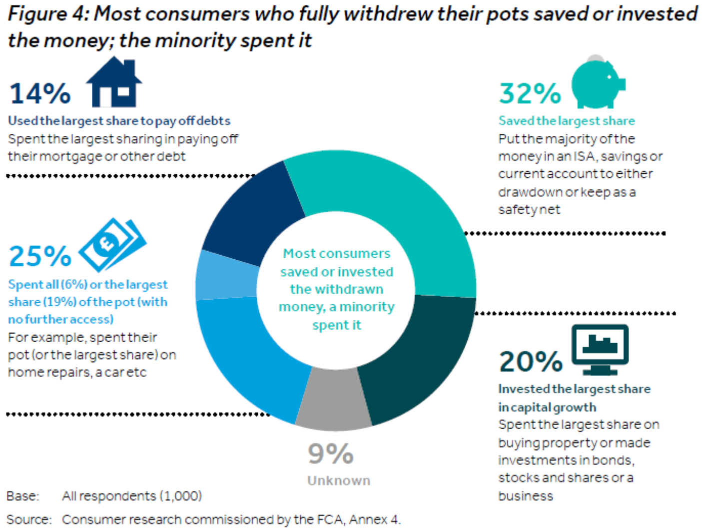


Source: Association of British Insurers' The New Retirement Market: Challenges & Opportunities, 2017.

Ahead of the adoption of the pensions freedoms, there was much speculation that they would allow a higher level of discretionary spending from those now able to access large amounts from their pensions savings more easily. However, the initial experience has shown that most fully withdrawn pots were invested, or used to pay down debts with only 25% spending all or most of their pot as illustrated in Figure 7. We would also expect that many of those making proportionally large or full cash withdrawals from a DC pension may have other pensions provision, either in DB or DC form, which tends to support the finding that individuals have generally been quite conservative in their approach to this area. It is also likely that many small pension pots are cashed in as it is not felt convenient to take a very small income from such pots.

Withdrawals have been found to be partly driven by a mistrust of pensions, and concern over possible future pension rule changes. In addition, full withdrawal was more popular amongst those aged less than 65.

Figure 7: Use of full cash withdrawals by investors



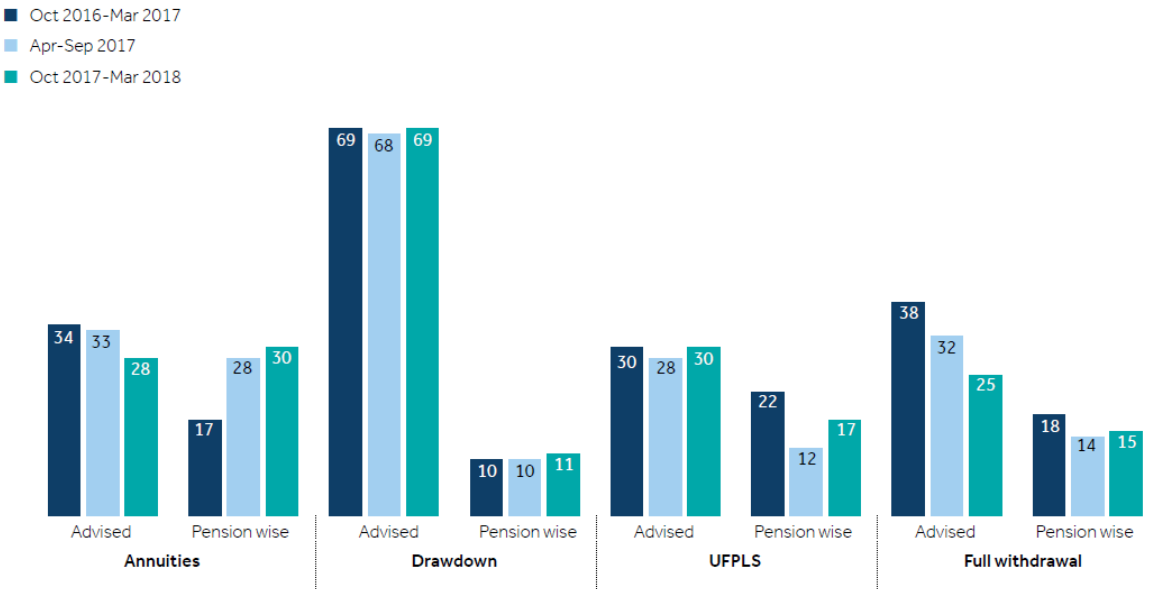
Source: FCA's Retirement Outcomes Review, 2017

4. Issues created for retirement decision making by freedom of choice

4.1 Complexity

The increase in pension freedoms has also led to an increase in complexity for investors looking to make retirement decisions, whether that is in retirement, at retirement or leading up to retirement. Deciding what to do with one's pension pot is, for many people, one of the biggest financial choices they will make in their lifetime. However, at present, many decisions around accessing pensions are taken without investment advice – the 2018 FCA Retirement Outcome Review noted that, since pension freedoms, there had been 'substantial shifts away from annuities and towards taking drawdown *without advice*'[1]. Figure 8 shows the proportion of people receiving regulated advice before making their retirement decision – apart from those people choosing income drawdown, less than a third have received regulated financial advice, which seems a low number for such a significant decision.

Figure 8: Percentage of product purchases and withdrawals where provider has recorded use of a regulated adviser or pensions guidance (October 2016 – March 2018)



Source: FCA Data Bulletin Issue 14, September 2018.[2]

[1] FCA Retirement Outcome Review, https://www.fca.org.uk/publication/market-studies/ms16-1-3.pdf
[2] FCA Data Bulletin Issue 14, September 2018.

There are a number of key factors which influence the decision that someone makes concerning their retirement provision, including:

- Income requirements and how these are expected to change over time
- Other sources of wealth and income outside pensions savings
- Tax situation of the investor, and the tax treatment of various options
- Life expectancy and any circumstances that would impact annuity pricing
- Dependants and their requirements
- Any expectations around inheritance in the future
- Desire for protection against the effect of inflation
- Level of investment knowledge and comfort
- Any desire for bequests or other gifts
- Risk tolerance for investments
- Desire for flexibility and the ability to react to changing circumstances
- Trust and confidence in the financial services industry

We explore some of these in further detail below. These elements can interact with each other in complex ways, increasing the difficulty investors face in making appropriate decisions without appropriate advice.

A further finding of the FCA review was that around one in three customers who had recently gone into drawdown were unaware of where their money was invested. Also, it found that a third of non-advised drawdown investors were fully invested in cash.[3] These two observations suggest that long-term investment considerations in particular are not being fully explored as part of the decision to enter drawdown.

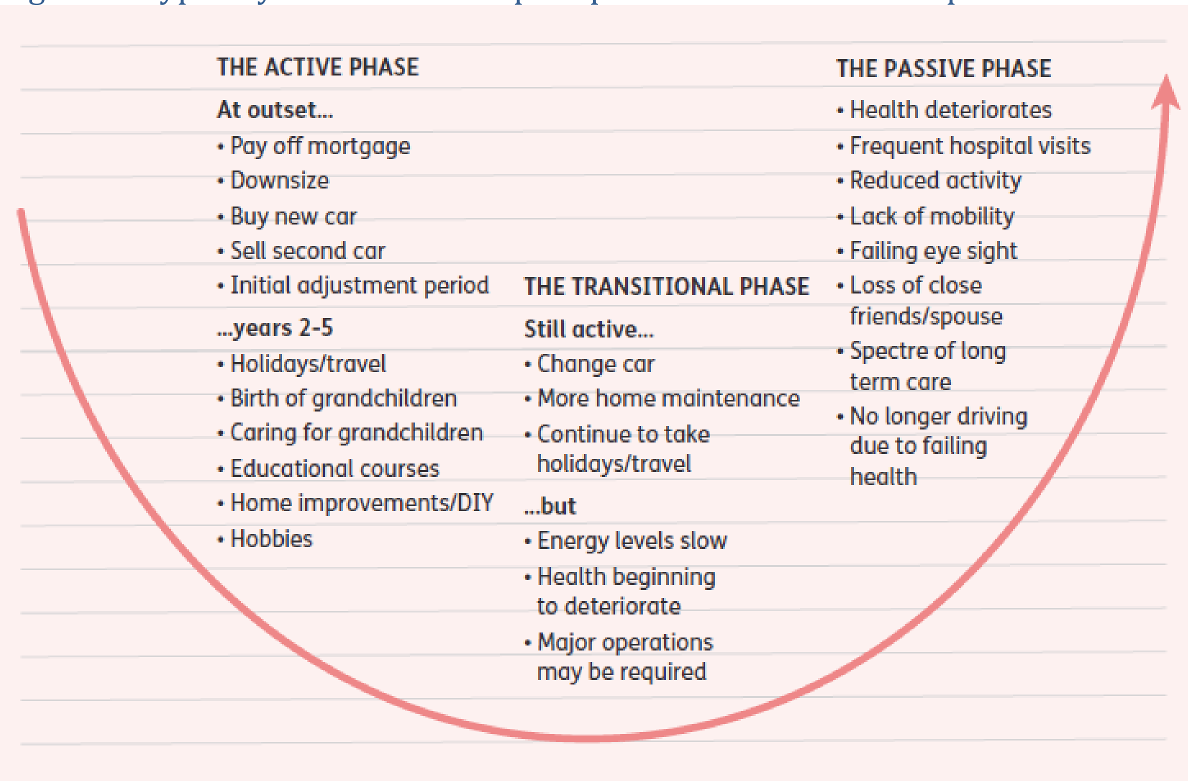
4.2 Spending in retirement

One way of assessing the suitability of a retirement product is to consider the spending patterns of different people in retirement.

Historically, a commonly held belief within the industry is that retirees have a ‘U’ shaped pattern of spending as their needs change - a typical example is shown here.

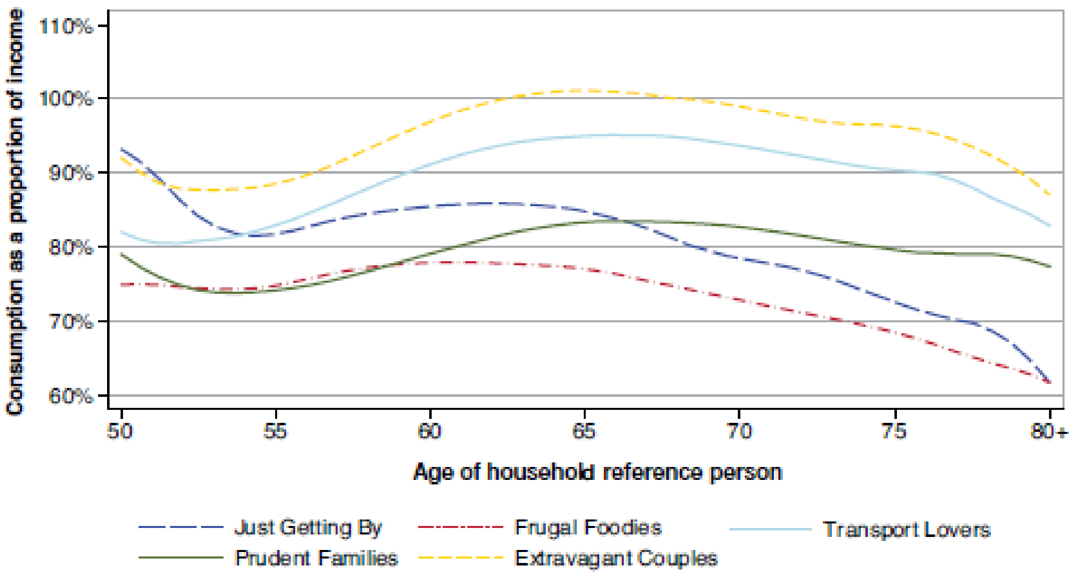
[3] FCA Retirement Outcome Review, https://www.fca.org.uk/publication/market-studies/ms16-1-3.pdf

Figure 9: Typically believed "U-shaped" pattern of retirement expenditure



More recent research, however, indicates that the "passive phase" is less pronounced than this. The International Longevity Centre's paper "Understanding Retirement Journeys: Expectations vs reality" highlights that spending reduces over the duration of retirement for all identified groups of individuals: as Figure 10 shows, spending is seen to tail off in the "passive phase" – there is no "U-shape"!

Figure 10: Spending (Consumption) patterns over time for different types of household



There is no doubt useful insight to be gained from looking at spending averages in retirement, either across a whole population or for different types of household. However, very few retirees will have spending patterns that match these averages – there is no such thing as an average retiree! Each individual retiree will have their own needs – either predictable and planned, or sudden and unplanned – with a wide range of considerations to be met, including those set out in section 3.1. This suggests that a product offering a fixed level of income is unlikely to be sufficient in itself to meet retirement needs and ambitions for all retirees, particularly as retirees' circumstances are very likely to change over the retirement period.

4.3 Trust & confidence in the industry

There is a wide range of recent evidence showing that investors' decision-making concerning their retirement savings – particularly decisions to withdraw from pensions products – is driven in part by a lack of trust in the financial services industry[4]. The FCA's Financial Lives Report[5] reports that 13% of investors feel that they have been mis-sold a product based on advice within the last 12 months, and only 40% of investors have confidence in the industry.

[4] Association of British Insurers' The New Retirement Market: Challenges & Opportunities, 2017, .New Choices, Big Decisions – Exploring Consumer Decision Making and Behaviours under Pension Freedom and Choice, amongst others.

[5] Financial Conduct Authority's Financial Lives Survey 2017

A subsidiary consideration, which has also been widely reported[6], is that investors fear that pensions regulations could change in the future, making access to pensions savings more difficult or expensive. This would tend to encourage people to access their funds at an earlier date than they might otherwise have done, for fear that they will be unable to access them as easily in the future.

Such uncertainty is particularly unhelpful given that investors will potentially be making some of the largest financial decisions of their lives when deciding what to do with their retirement funds, without having the benefit of making such transactions previously which may have built confidence and familiarity.

A lack of trust in the financial services industry is perhaps understandable in light of the numerous high profile scandals and mishaps with which it has been associated in recent decades. Writing in 2004, Ring cited personal pensions mis-selling, free-standing voluntary contributions, endowments, with-profits policies, split capital investment trusts, 'precipice' bonds, and the Equitable Life affair as examples of such problems[7]. Since then, we have seen the global financial crisis of 2008, the hugely costly PPI mis-selling affair and other high-profile issues such as the LIBOR scandal.

More recently there has been widespread coverage of 'pensions scammers' in the wake of the pensions freedoms being introduced[8].

There is a substantial academic literature on the general nature and attributes of trust, although considerably less on trust in financial services. Generally, research dealing with the financial services area agrees that trust is of key importance for two key reasons: the products sold are complex and potentially risky; and there is normally a considerable difference between the expertise and knowledge of provider and the customer. It is clear that both elements are often present in making long-term retirement investment decisions. One thing to note is that trust is a multi-disciplinary concept that is not easy to define[9]; however, a useful and straightforward formulation that has been employed in research on Financial Services is to contrast cognitive, or lower-level, trust (broadly

[6] One such example is New Choices, Big Decisions – February 2016, SSgA and the People's Pension
[7] Ring, P.J., 2005. Trust in UK pensions policy: a different approach?. Policy & Politics, 33(1), pp.55-74.

[8] https://www.dailymail.co.uk/news/article-6642131/Hundreds-pension-scam-victims-lose-91-000-two-conned-1million-nest-eggs.html https://www.express.co.uk/news/uk/1086750/pension-scans-fraudsters-millions-pounds-investigation-uk https://www.bbc.co.uk/news/business-46799038
[9] Moin, S., Devlin, J.F. and McKechnie, S. 2015. Trust in financial services: Impact of institutional trust and dispositional trust on trusting belief. Journal of Financial Services Marketing 20(2): 91–106.

whether the provider has the competence to deliver on its promises), and affective, or higher level trust (broadly whether the provider has the customer's best interests at heart)[10].

Arguably (in light of the many scandals listed above), the lack of trust in the industry is irrational, as the industry is well regulated. The Financial Conduct Authority has clear purposes to protect consumers, enhance integrity within the market and promote competition between providers of products and advice. Many of the problems mentioned above, which are directly relevant to the pensions market, are now rather a long time in the past, although certainly within the experience of people approaching pension age. Many commentators and possibly the public are, however, perhaps not inclined to differentiate very precisely between different sectors of the financial services industry, and problems in banking may be taken as reflecting badly on pensions providers.

There is certainly no doubt that lack of trust is often fuelled by media coverage, and actions of claims management companies seeking compensation for their clients, which highlight negative stories[11]. There is, however, an empirical body of work on long-term trends in consumer trust in the UK Financial Services sector, which provides evidence of higher levels of trust than one might expect from the foregoing [12]. To give a very broad summary, the sector as a whole compares surprisingly well to other institutions, such as, the BBC, the NHS and other industries that tend to receive much less criticism in the media. There are also considerable differences in the way that different parts of the industry are currently perceived with banks being perceived relatively very badly, brokers/advisors relatively very well and life assurance companies by no means as badly as banks.

In conclusion, there is no doubt that trust is a key factor, and keeping and improving it is very important for the industry. Although trust in the Financial Services sector is relatively low, the situation for providers most associated with pensions is perhaps not as bad as some commentators tend to portray, so there appears to be a reasonable basis of trust upon which the industry can build.

4.4 Age considerations & behavioural aspects

[10] Sekhon, H., Devlin, J.F. and Roy, S. Fairness perceptions in financial services: An analyses of distribution channel. International Journal of Bank Marketing. 34(2): 171-190.

[11] Reasons for mistrusting advisers: https://www.moneymarketing.co.uk/issues/23-november-2017/mistrust-advisers-neil-liversidge/

[12] Devlin, J., Ennew, C., Sekhon, H. and Roy, S 2015 Trust in financial services: Retrospect and prospect Journal of Financial Services Marketing 20: 234-245.

An unintended possible consequence of the pensions freedoms is that it may require on-going, complex decision-making from those who may be less well-equipped to make such decisions over time. A considerable body of research in behavioural economics and finance shows that individuals may generally have problems making decisions that are financially optimal. In this context, these problems may be somewhat compounded by the fact that the people involved will be generally in later life. In this sub-section, we initially discuss some of the general behavioural issues in financial decision-making, followed by an outline of some factors that are particularly relevant to older individuals. Finally, we discuss how some of the issues in this area can be managed.

When looking into how individuals make decisions, traditional economists often use models in which all people set out to maximise their own interests (or utility). However, there are many situations in which an investor's behaviour does not fit well into such models and an investor exhibits one or more "irrational biases". For example, in the context of pensions, there is a substantial body of literature seeking to explain the 'annuity puzzle', the observation that people have generally been much less keen to purchase annuities than standard economic theory would suggest. We highlight some of the more common biases that have been encountered in research literature below:

- Investors have short time horizons (short term bias) and prefer a small reward now rather than a larger reward in the future. This bias is associated with high rates of discounting[13] and sometimes mental models of discounting, such as hyperbolic discounting[14], which are not consistent with rationality. ('Discounting' refers to the extent to which an individual prefers a reward now vs a reward at various times in the future. An individual with a higher discount rate receives less satisfaction from a future reward than an individual with a lower discount rate would in the same situation.)
- Investors fear loss more than they value gain[15], which implies that certainty is preferable to uncertainty, even when potential 'uncertain' rewards might be greater.(Associated with this is a tendency to see annuities as a gamble on whether one will live long enough to 'win' a cumulative amount of income that exceeds the original cost of the annuity[16].)
- Individuals may display an 'optimism bias' in considering the future, so thoughts of dying and running out of money tend to be ignored in favour of more positive situations.
- People may overweight small probabilities in some circumstances; for example, they may place too much weight on the probability of dying soon after buying an annuity.

[13] Warner J. T, Pleeter S. (2001) The Personal Discount Rate: Evidence from Military

Downsizing Programs, The American Economic Review, Vol. 91, No. 1., 33-53.

[14] Laibson, D., 1997. Golden eggs and hyperbolic discounting. The Quarterly Journal of Economics, *112*(2), 443-478.

[15] 28-september-2017/53-gregg-mcclymont

[16] Hu, W., & Scott, J. S. 2007. Behavioral obstacles in the annuity market. Financial Analysts Journal, 63(6), 71–82.

- People may use simple, and sometimes misleading, heuristics[17] to make decisions. For example, someone might evaluate their annuity quotes by dividing the purchase price by an estimate of their life expectancy[18].
- Salience bias[19] may tend to make people favour alternatives with which they are most familiar; for example, perhaps residential property in the retirement savings domain.
- There is a considerable body of work relating to biases in investment, which is now very pertinent to pensions-related decisions in the current environment, in which there is much more choice over investment in the decumulation phase:
  - Periods of high and low sentiment may affect the propensity of people to make riskier investment choices[20].
  - Availability bias may cause people to overweight evidence from recent time periods[21].
  - People are prone to diversify very crudely and inefficiently; for example, when presented with a range of alternatives, people simply put an equal share of their money in each alternative[22].
- It should be noted that people are fairly heterogeneous in their attitudes, so different individuals may not be similar in any biases they display, which considerably complicates matters in this area.

These and other biases help explain observed decision-making in relation to pensions saving. People are reluctant to engage fully in the decision making process and often the outcomes run counter to those suggested by financial economic theory. We see that few people feel confident in their ability to make decisions related to retirement savings. There is, nonetheless, a reluctance to take formal advice, with cost being an issue for many particularly given the distribution of pot sizes. Even in the relatively complex area of drawdown products 30% of people had not taken advice. There is little evidence that people 'shop around' for drawdown or annuities, especially in the absence of advice.

In addition, there is often little engagement with what to do with the remainder of the pot after partial withdrawal.

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[17] 'Heuristics' are rules of thumb – relatively simple ways to take decisions that are not necessarily mathematically optimal. Depending on the context, using them might be a very bad idea or could be a reasonable way to proceed.

[18] Duxbury, D., Summers, B., Hudson, R., Keasey, K. 2006. How people evaluate defined contribution, annuity-based pension arrangements: A behavioral explanation, *Journal of Economic Psychology* 34, 256-269.

[19] 'Salience bias' is the idea that individuals are most likely to focus on the most prominent information when considering an issue. For example, if there is news of a plane crash all over the papers it will probably somewhat affect their views of flight safety. 'Availability bias' is a very similar concept. It is the idea that when making decisions people tend to focus on the information that comes most readily to mind.

[20] Baker, M. and Wurgler, J., 2006. Investor sentiment and the cross-section of stock returns. The Journal of Finance, *61*(4), pp.1645-1680.

[21] Barberis, N. and Thaler, R., 2003. A survey of behavioral finance. *Handbook of the Economics of Finance*, *1*, pp.1053-1128.

[22] Benartzi, S. and Thaler, R.H., 2001. Naive diversification strategies in defined contribution saving plans. *American economic review*, pp.79-98.

People frequently make decisions that are not based on rational or informed analysis. The attraction of an immediate lump sum of cash is very strong, especially if it is tax free. Property or cash ISAs are often seen as preferable to investing via a pension, even if these are less favourably treated for tax purposes. There is a long-standing aversion to purchasing annuities. Overall, too much choice can faze investors with one of the reasons cited for Guaranteed Drawdown products not being more popular is that they are an additional (and arguably more complex) choice[23].

Research highlights a number of factors that are particularly relevant for ageing investors. Cognitive ability declines, particularly from age 75 onwards, making it harder to understand the options and products available. A lack of willingness to use technology amongst older investors might impact on the attractiveness of "robo-advice"[24]. The Financial Lives Report suggests 2/3rds of investors stick to a brand they know, and the percentage increases with age[25]. Not unreasonably, independent organisations are seen as the most trusted sources of information.

A number of approaches can help individuals to make more informed choices. A better presentation of information can be very helpful. People find it easier to engage with actual monetary amounts when it comes to establishing retirement needs. It is also preferable if these are related to actual purchases a retiree may make[26]. In Australia, for example, The Association of Superannuation Funds of Australia (ASFA) produces the ASFA Retirement Standard, which benchmarks the annual budget needed to fund either a comfortable or modest standard of living in the post-work years. It is updated quarterly to reflect inflation, and provides detailed budgets of what single people and couples would need to spend to support their chosen lifestyle. Certain methods can be used to 'nudge' people into making more informed decisions. A relevant example of using a 'nudge' is auto-enrolment. It is very helpful to encourage people to take suitable advice. Another helpful approach is to Increase financial education to improve the financial knowledge of individuals.

In summary, there are many complex behavioural issues at play in this area, many of which are not fully understood. It cannot be assumed that people are naturally going to make appropriate choices – there is significant evidence that suggests that they will not. However, there are a number of pragmatic ways to deal with this problem, for example: increasing the level of advice provided

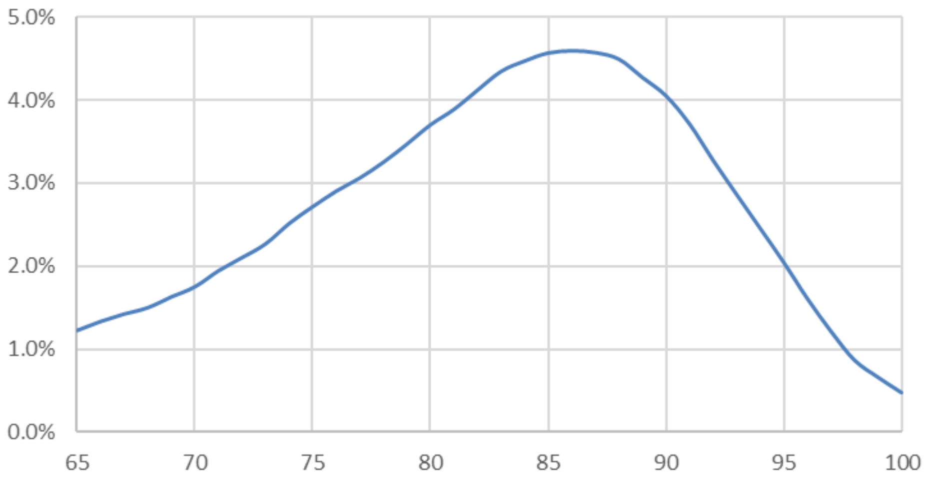
[23] guaranteed-drawdown-like-mixing-oil-water
[24] financial-services-got-wrong-clients-want-technology
[25] advisers-need-face-facts-clients-still-dont-trust
[26] Pensions and Lifetime Savings Association (PLSA) – Hitting The Target: https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2017/Hitting-the-target-delivering-better-retirement-outcomes.pdf?ver=2017-10-10-120119-607

(whether from human or 'robo' advisors); and helping to guide people towards more informed choices with appropriate presentational techniques or 'nudges'.

4.5 Demographics

A major difficulty faced by individuals at retirement in estimating their future spending needs is understanding how long they are likely to live. For example, the below exhibits, which show respectively the likelihood of a male and a female currently aged 65 dying at each age between 65 and 100, show the variation within the population of mortality rates.

Figure 11: Indicative male mortality rates, UK Life Tables 2015-17[27]



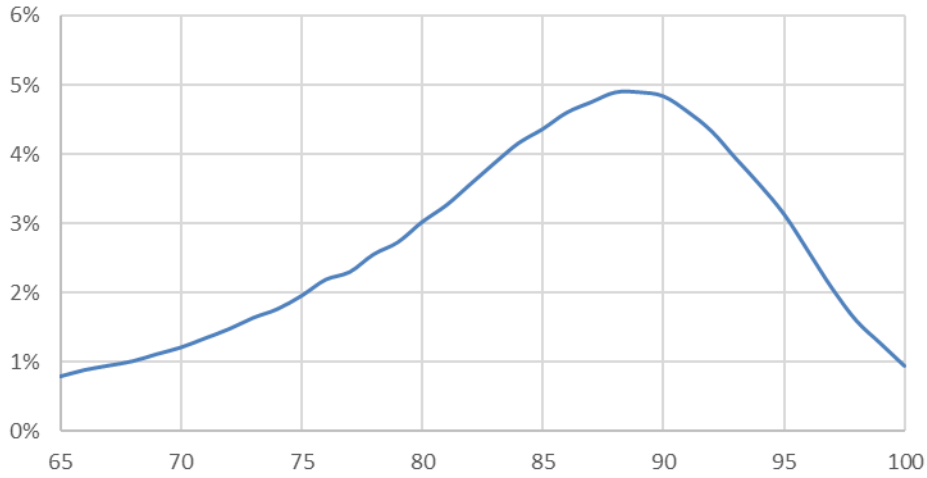
The difference between first quartile and third quartile life expectancy, for example, is 12 years, from 77 years to 89 years – a difference of planning horizon of from 12 to 24 years.

Figure 12: Indicative female mortality rates, UK Life Tables 2015-17[28]

-

[27] Period life expectancy for a male aged 65, taken from the National Life Tables for the UK for 2015-17

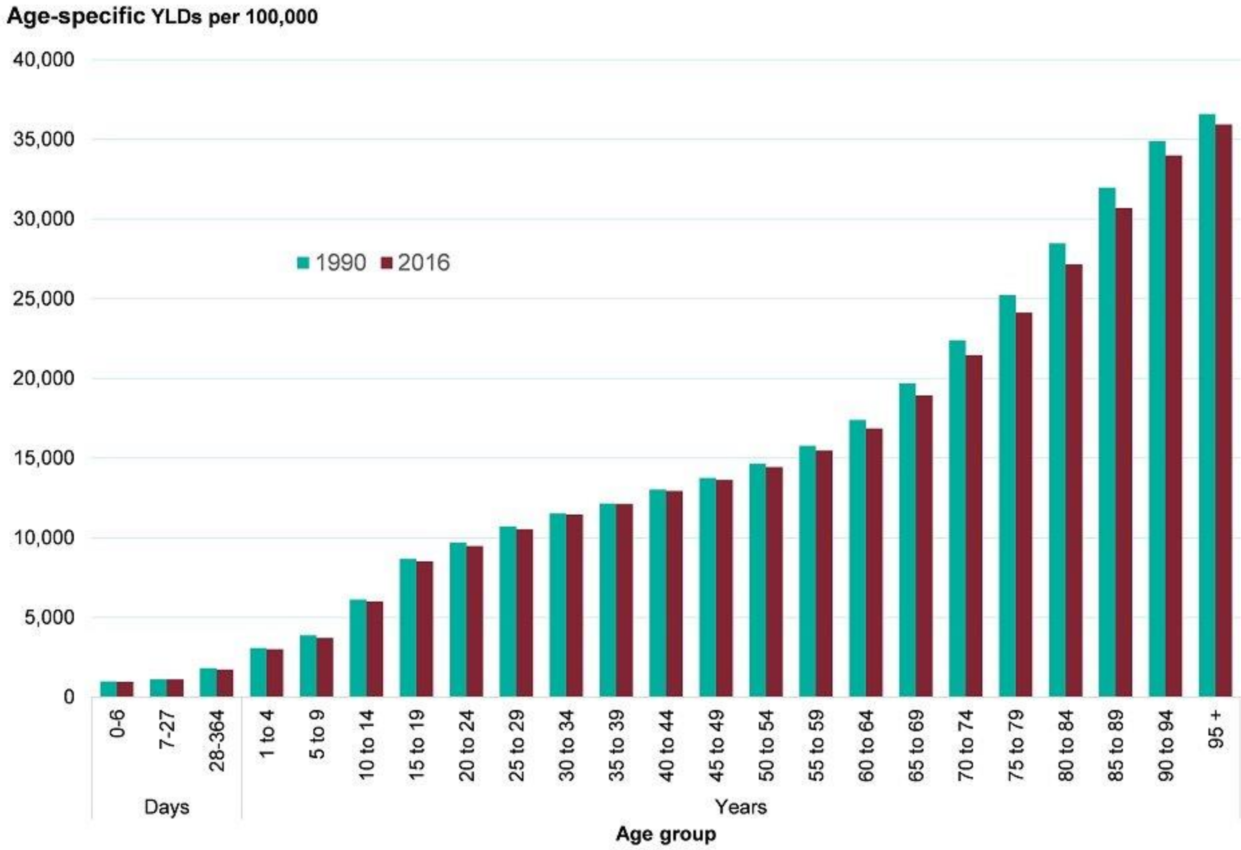
[28] Period life expectancy for a female aged 65, taken from the National Life Tables for the UK for 2015-17



The difference between first quartile and third quartile life expectancy, for example, is also 12 years, from 80 to 92 years.

This is before considering the impact of potential extra costs of living with illness. Although rates of morbidity for those in later life have been declining, these continue to increase with age.

Figure 13: Indicative morbidity for UK population, split by age[29]



Source: Global Burden of Disease Study 2016 (GBD 2016) Results. Seattle, United States: Institute for Health Metrics and Evaluation (IHME), 2016

[29] "Years lived with disability" (YLDs) is a measure of morbidity used in the Global Burden of Disease study (GBD) that combines the prevalence of each disease with a rating of the severity of its symptoms (excluding death itself), to give an overall measure of the loss of quality of life.

4.6 Summary

We are left with a 'perfect storm' in which investors need to make arguably the most important decisions of their lives at a time when their ability to make rational and informed decisions is diminishing. Individuals must make these decisions in a minefield of complexity, with insufficient advice and dealing with institutions they do not trust. It is therefore perhaps not surprising that outcomes can often be sub-optimal.

5 Remedies

5.1 Engagement

Pensions have always been a complex area. The Pensions Freedoms regulations introduced in April 2015 provided significantly more flexibility for investors, but with that flexibility came even more complexity and significantly more risk. This additional risk arises in the sense that there is now more scope for individuals to make inappropriate decisions, which can have long term negative consequences given the amounts of money involved and the stage of life at which such decisions occur.

Investors can now access their pension arrangements freely after age 55 whereas previously there were considerable restrictions on how these monies could be accessed. There were designed, in large measure, to make sure that investors acted in a very conservative manner – an annuity, after all, offered an income for the remainder of the life of the investor, even if this was fixed in nominal terms.

In contrast, there are now a range of options available to investors who are seeking either income or capital growth in retirement, and many products available in the market to facilitate these options. Most examples still include many aspects of traditional products available from insurers:

- Lifetime Annuities (nearly always, although not necessarily, based on savings in pension arrangements).
- Drawdown (based on savings in pension arrangements), potentially with some form of guarantee around the level of either capital or income.
- Equity Release (based on the individual's own dwelling).

However, the need for income in retirement can also be met by other assets held by investors outside pension arrangements, including:

- Stocks and shares
- Life insurance policies
- ISAs
- Unit trusts
- Buy to let properties

- The investor's own property

In addition, other sources of income may be available to investors throughout retirement:

- State pension
- Occupational pensions from one or more employers

Furthermore, the taxation rules governing amounts of income and capital which can be drawn are complex. So the decision on how to utilise different pools of assets to generate an income at any given point in retirement, and ensure that this is sustainable to meet future needs, is both a very individual and a very difficult one.

Engagement of investors in their pension arrangements is key, but the level of this engagement is a key concern for policymakers and regulators globally. As pension income provides the retirees with a wealth to maintain a standard of living when they have limited or no earnings, it is important for the retirees to engage in managing this wealth and make the right decisions to maximize the underlying benefit. The increased freedom to access the pension pot and the wealth of available options to invest their pension pot money may lead individuals to making less informed decisions which affects their lifetime income post retirement.

With the availability of more investment products, many of which do not provide a downside risk guarantee or assurance, the search for excess returns requires the investors to be more engaged to manage their money throughout and in such instances financial advice can prove to be helpful.

Many providers of retirement products provide online tools to support investors in their retirement journey in an attempt to provide simplicity and engagement. The development of such a tool was also the major focus of a recent Institute and Faculty of Actuaries' Working Party on Retirement Choices.

5.2 Advice

Evidence exists that advice leads to better financial outcomes for investors, yet many do not take advice. Based on the study provided under "The Value of Financial Advice[30]" published by the

[30] ILC-UK The Value of Financial Advice

International Longevity Centre, it was found that there are multiple reasons adding advice can lead to achieving better financial outcomes including:

- Increasing amounts of savings
- Appropriate choice of product and investments to manage the pension money,
- Financial advice available

There are many possible reasons for investors not taking advice:

- Investors are often not sure if they require advice or guidance to make better decisions. This is also driven by investors own knowledge of investment vehicles and products.
- Availability of a wide range of financial advisors leads the investors to be confused about the right advice and advisor for their circumstances.[31].
- The financial advice could be costly especially for the investors having a small pot of money. Considering the low interest rate environment where the investment products are struggling for a reasonable return when combined with the cost of financial advice could lead to negligible returns for the investors.[32].
- Advice can often be branded 'wealth management', and investors with less than £25k saved do not see themselves as wealthy[33], and so do not view advice as worthwhile.
- Lack of trust in the industry, for both IFAs and providers (see section 3.3), means that investors often base decisions on opinions and experiences of family members and friends, and on information gleaned from the press and other media.

A significant proportion of Money Marketing readers (1/3rd) believe that advice should be compulsory when accessing drawdown[34], but the proportion of investors taking advice prior to fully cashing in their pot is decreasing[35].

'Robo-advice' may help to address the advice gap for investors with small pots, as it can be relatively inexpensive, and there are a small number of providers of such advice[36][37]. However, there are regulatory and market concerns in areas such as the applicability of such models to investors' unique circumstances, for example, causing some providers to delay plans to implement such tools, as well as firms' own operating models[38]

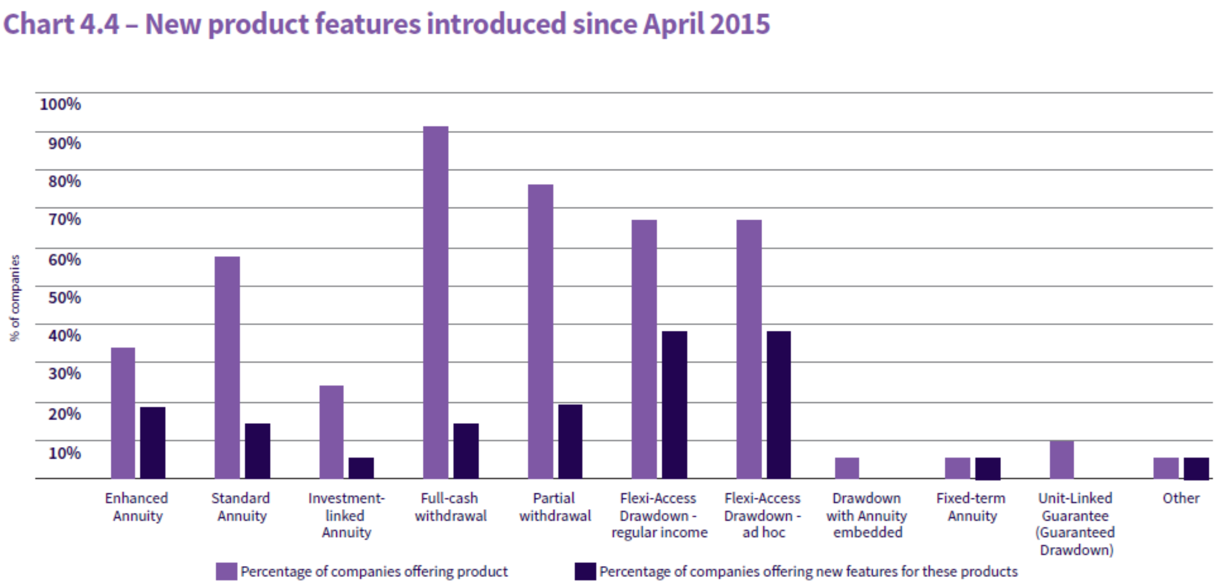
[31] challenge-clients-choosing-adviser
[32] fca-chief-low-interest-rates-putting-people-off-advice
[33] consumers-brand-investment-advice-pointless-25000
[34] advice-drawdown-pensions
[35] fewer-consumers-using-advisers-full-pension-withdrawal
[36] hsbc-targets-small-investment-pots-robo-offering
[37] lv-backs-robo-advice-boost-pension-profits
[38] profitability-pains-robo-advice-market-stalls-plans-financial-fears

5.3 Product evolution and innovation

Given the distribution of product sales highlighted in the first section, it is perhaps unsurprising that many insurers have refocused their strategies on drawdown rather than annuities, with several providers leaving the annuity market[39]. Indeed, a potential future lack of competition in the annuity markets has been highlighted as an area of possible concern by the FCA[40].

There have been a range of new or evolved products launched by both insurers and asset managers in light of the new freedoms. These may include a range of investment options, target levels of income, income or capital guarantees or enhanced payments to beneficiaries. In terms of the now larger drawdown market, there has been little evidence of one approach to drawdown or decumulation products becoming dominant.

Figure 14: New product features introduced since pensions freedoms



Source: ABI

However, in a 2017 report the FCA have highlighted the lack of development of products combining flexibility and guarantees for mass market consumers who do not take advice. Guarantees are, or may be seen as, expensive by consumers, and not necessarily providing value for money. Some providers offer with profits investments, which give an element of smoothing to reduce volatility; however, this provides no guarantees in itself.

[39] https://www.ftadviser.com/pension-freedom/2018/04/12/state-of-the-annuity-market-3-years-after-armageddon/

[40] FCA Retirement Outcomes Review, Interim Findings, 2017.

Many providers have focused more on developing tools to help consumers understand their options, rather than product innovation. For example, Scottish Widows have introduced a drawdown income tool, which generates flexibility in balancing and optimising tax free cash and drawdown income[41]. This is one example of many such offerings.

However, comparisons of different products remains challenging, especially the different types of features offered within different products. We highlight a range of these at a high level in section 4.4.

[41] https://www.moneymarketing.co.uk/scottish-widows-launches-new-drawdown-income-tool/

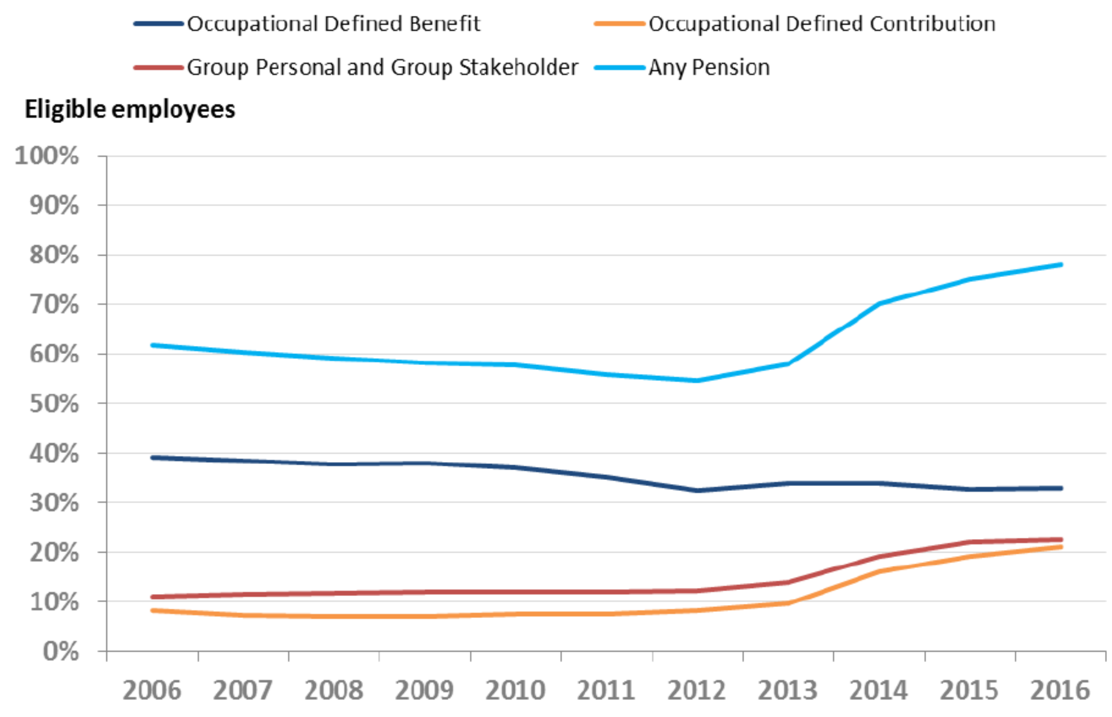
It can be easily seen that the relative appeal of many of these features may change for investors at different stages of their retirement, so retaining flexibility to alter choices through time is likely to be attractive.

5.4 Default options in decumulation

Auto-enrolment has had a major positive impact on saving throughout the accumulation phase of retirement planning.

Figure 16: Workplace pension participation rates, 2006-2016

Figure 2.1 – Workplace pension participation rates in the public and private sectors have reached 78 per cent in 2016



Source: DWP Automatic Enrolment Review 2017: Maintaining the Momentum

Participation rates have risen sharply, and total annual contributions into workplace pensions reached a ten year high of £87bn[42] in 2016. There is a school of thought which suggests that auto-enrolment does not go far enough in addressing accumulation needs, and that its' scope should be widened and

[42] Source: DWP Automatic Enrolment Review 2017: Maintaining the Momentum

contribution rates increased[43]. The risk that current savings levels risk a significant proportion of the working age population not meeting their retirement expectations was identified by the Department of Work & Pensions in their 2017 review of Auto-Enrolment as a strategic issue.

In retirement, there is evidence of people becoming disengaged from retirement planning, for reasons expressed elsewhere in this paper. Since the advent of pension freedoms there has been no default option put in place for those reaching retirement age with a defined contribution pension pot – previously the default was to invest in an annuity for many. However, in April 2018, the Parliamentary Work and Pensions Committee recommended that default pensions decumulation routes should be introduced. Any providers that offer drawdown products would be required to offer a default option. Default drawdown products would be subjected to the same 0.75% charge cap as the default accumulation of auto-enrolment schemes. This proposal is not to be actioned in the government in the immediate future, amidst concerns around what impact such a cap would have on product innovation and investment approach[44]

The 2018 FCA Retirement Outcomes Review built further on this, by suggesting three 'investment pathways' for drawdown, reflecting an earlier proposal from the same body that a default decumulation pathways is implemented.

These pathways reflect the following standardised objectives:

-I want my money to provide an income in retirement

-I want to take all my money over a short period of time

-I want to keep my money invested for a long period and dip it into it occasionally.

It will be interesting to see if this proposal leads to further innovation in the decumulation product space, and what feature such products would have.

As noted previously, it may be that the objectives of investors change over time, for example, moving from the third pathway to the first if other sources of income were to be depleted. So the ability for investors to move across pathways later in retirement would seem to be desirable.

[43] PLSA – Hitting The Target: https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2017/Hitting-the-target-delivering-better-retirement-outcomes.pdf?ver=2017-10-10-120119-607
[44] http://www.pensions-expert.com/Law-Regulation/Should-the-FCA-set-a-drawdown-charge-cap?ct=true

Figure 17: Features for retirement products

Product feature	What it offers	Key attraction	Key drawback
Guarantee of income for whole life	Income is paid for as long as the person remains alive	Peace of mind in the face of uncertain longevity	Cost of such guarantees are seen as expensive e.g. annuities
Liquidity	Ability to retrieve current value of capital without undue delay or cost	Easy to make changes if circumstances change	Some guarantees may not be compatible with this feature
Income	Regular payment of a yield from a product, either natural or otherwise	Natural sources of income (e.g. dividend yields, bond coupon) may be seen as 'sustainable' in the long term	Amount of income paid may not be aligned to investor's needs
Stability of capital value	Not exposed to large increases/falls in value over the short term, due to market movements or otherwise	Sudden changes in value of a retirement pot may require sharp changes in spending plans	Less investment risk will reduce the long term expected growth of a retirement pot
Inflation linkage	Capital or income increases in line with a defined inflation measure	Cushions investor from erosion in living standards due to higher inflation	Cost of such guarantees means they are often unattractive in practice e.g. index-linked annuities

Death benefits or value on death	Defined amounts or residual value paid to dependants	Peace of mind and lessens fear of losing out due to early death	Lessens amount available to generate income for the investor
Flexibility	Ability to change income level or investment strategy or product	Easy to make changes if circumstances change	Not available on products such as annuities
Ease of engagement	Ability to get information or make changes quickly and easily	Builds comfort and potentially trust	Scope for poor decision making, perhaps due to behavioural biases

5.5 Balance Sheet Approach

An approach discussed within the working group has been to express an individual's wealth/assets and expected/contingent outgo in the form of a balance sheet.

Given that investors often have reasonably short time horizons, it is proposed to split outgo into short term, which may cover the next 2-3 years; and longer term, which is likely to be more speculative, or at least less certain. Assets would also be categorised into those that are sufficiently liquid to provide income in the next 2-3 years, and those which are illiquid and can be used for more distant liabilities.

In terms of assessing outgo, it would be possible to use criteria similar to those used in the Australian model proposed in the PLSA's paper: Hitting The Target[45], or minimum income standards as identified by the Joseph Rowntree Foundation.

The balance sheet would be refreshed every 1-2 years, to reassess assets and liabilities.

The challenges with such an approach relate to making it sufficiently simple to be both understandable and engaging, and determining ways of stating both capital and income in a consistent manner.

[45] PLSA – Hitting The Target: https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2017/Hitting-the-target-delivering-better-retirement-outcomes.pdf?ver=2017-10-10-120119-607

5.6 Overall findings

- The introduction of pensions freedoms in 2015 has had a major impact on decision making for investors approaching, at, and beyond retirement age.
- The increasing use of drawdown products and cash withdrawals, and reduction in annuities purchased, are amongst the most noteworthy of these changes and suggest that the freedoms have allowed investors to alter their behaviour from that seen before 2015.
- We note that the use of the resulting freedoms has not been uniform, with full cash withdrawal, annuity purchase and income drawdown being relatively more attractive for different sizes of retirement savings, for example.
- One benefit of increased freedoms is that a single, one-off and irreversible decision against the backdrop of considerable uncertainty, such as the purchase of an annuity on retirement, is less likely. A key drawback, however, is the lessening ability to make repeated complex decisions around the use of retirement savings in later life.
- We would argue that the choice of what to do with retirement savings is one of the major financial decisions investors will make in their lives. There are a wide range of considerations to be taken into account, including a number of complex and long term variables e.g. life expectancy, inflation proofing, tax treatment, care costs and requirements for dependants.
- Unfortunately, there is little evidence that the pensions freedoms have led to an increased engagement with long term pensions planning or sophistication in decision making from investors. Clearly, this will become an increasing issue as Defined Contribution pensions savings make up an increased proportion of total retirement savings.
- Trust in both the pensions savings framework and current providers of such products would seem to be an issue for at least a minority of investors, as seen by the number of withdrawals which were subsequently invested in less tax efficient but arguably more familiar vehicles e.g. ISAs. A related issue is the reluctance to pay for investment advice to support such decisions. We note, however, for smaller values of retirement savings, such advice may be either prohibitively costly or unavailable.
- We believe that the needs of investors will often be quite different, both across investors and for the same investor at different stages in their lives. While the wide range of various product features and options available to investors is welcome from this perspective, it can make direct comparisons and decision making difficult.
- We also acknowledge that retirement savings is only one source of support for those in retirement, although often a vital one. Other savings and investments, as well as the state pension, will have a key role for many investors in maintaining their standard of living in retirement.
- We believe that, for many, the interplay between the capital value of assets and the more recurring nature of investment and other income, as well as expenses, makes decision making difficult. This is especially the case where both capital values and expenses can be subject to large changes in the short to medium term.

- With this in mind, we see the adoption of an 'Income Balance Sheet', allowing for the easy transformation from current or anticipated income and outgoings to capital value of assets and liabilities as being a useful approach. While there may be a number of actuarially sound representations, we believe that such a view of all current and future anticipated inflows and outflows to be useful, particularly in planning over a 1-3 year time horizon.
- Such a framework also allows for clear planning and subsequent decision making in a familiar manner in future periods. It may also work well in an environment where default pathways for decumulation are made available, showing the anticipated impact of different choices in a consistent manner.

5.7 Next steps

- Further development of the Income Balance Sheet concept and consumer testing if this is deemed to be potentially of use to investors in making decisions in retirement planning
- Further work on the experience in other countries e.g. Australia where differing models of retirement income provision are widespread
- Better understand the impact of the time value of money in long-term retirement investment decision making for individuals
- Expand on the findings of the Working Party in terms of implications for robo advice and other tools to aid decision making.

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