Default retirement income strategy

Independent Яeview of Retirement Income

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Agenda

- Needs and risks in retirement
- Retirement income planning
- Retirement financial strategy
- Retirement income products
- Withdrawal strategy
- Longevity insurance strategy
- Default retirement income/expenditure plan
- Safe harbour status
- Modelling outcomes and establishing value for money
- Conclusions

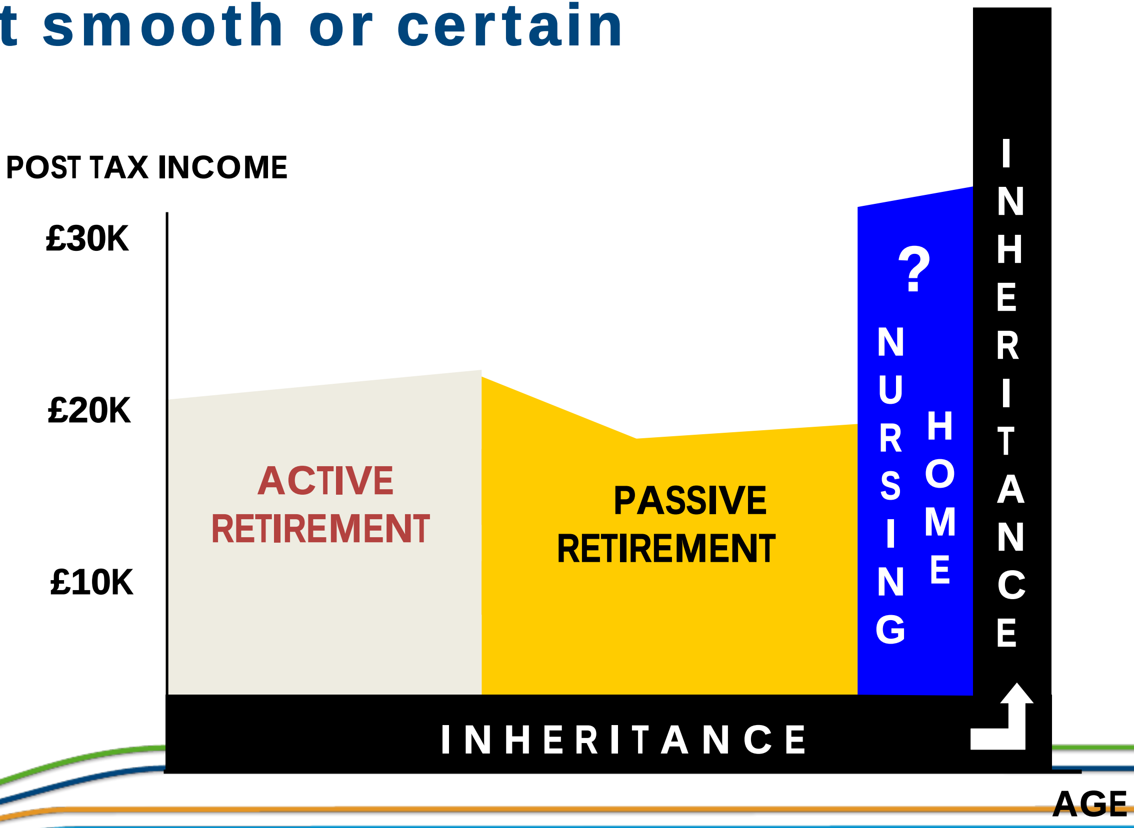
Definition of a pension plan

- To provide retirement income security for however long a plan member lives

- Plans that provide lump sums only are savings plans <u>not</u> pension plans

Needs and risks in retirement

Income needs in retirement are not smooth or certain



Risks in retirement

- Interest rate risk when annuity is purchased
- Inflation risk
- Investment and reinvestment risk
- Longevity risk:
  - outliving resources
  - leaving unintended bequests
  - failure to leave intended bequests

Risks in retirement

- Care risk
- Change in circumstances:
  - partner becomes dependent
  - partner dies
- Changes in taxation

- Pensioners have limited understanding of these risks but now faces them directly
  - without the benefits of risk pooling

Variability in life expectancy

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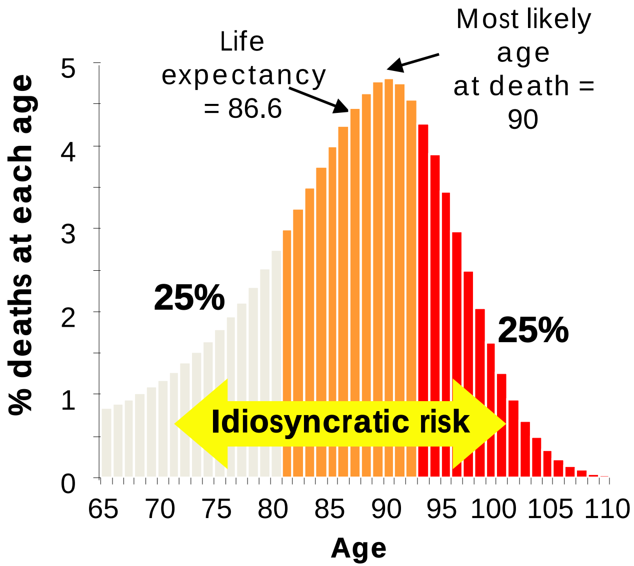
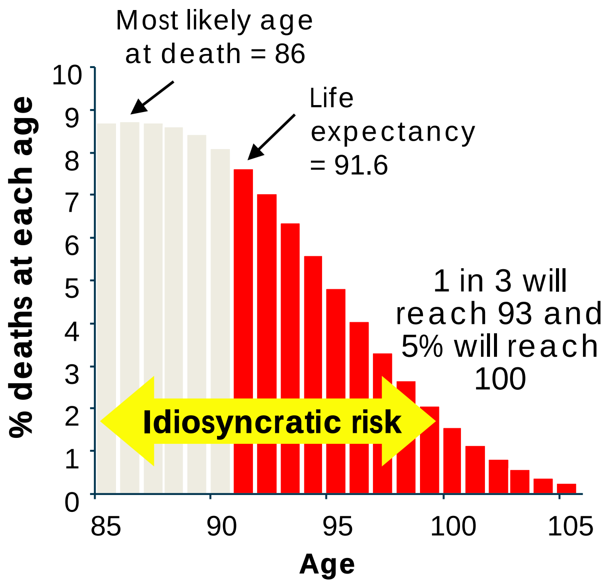
Expected distribution of deaths: male 65



1 in 1000 chance of living twice life expectancy at age 65

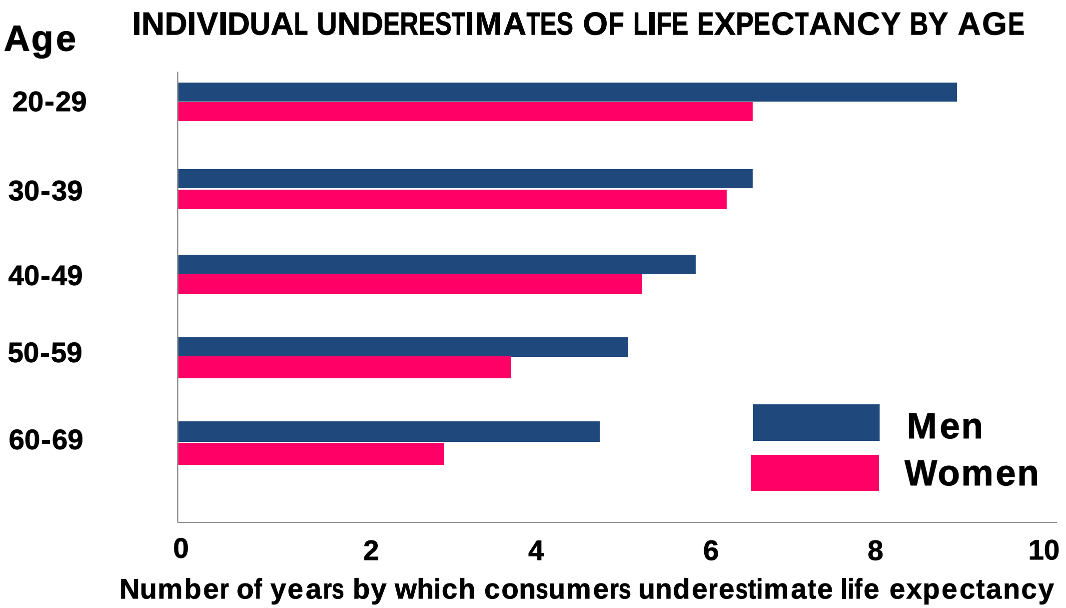
Expected distribution of deaths: male 85



1 in 10 chance of living twice life expectancy at age 85

Source: 100% PNMA00 medium cohort 2007

Individuals consistently underestimate how long they will live…



Sources: O'Brian, Fenn, and Diacon, 2005, self-estimated life expectancy compared with GAD forecast life expectancy; own analysis.

Retirement income planning

Retirement income planning is inevitably about tradeoffs

- Income and expenditure today **V** Income and expenditure later
- Higher income and expenditure **V** Higher inheritance
- Protecting against future inflation **V** Higher immediate income
- More investment risk **V** More certainty
- Buying longevity insurance **V** Taking risk

- Mass market does not fully understand these tradeoffs and needs to be nudged via default pathways
  - using decision trees

Retirement financial strategy

Retirement financial strategy

- Investment strategy
  - strategy for investing the pension pot
- Withdrawal strategy
  - strategy for withdrawing cash from the pension pot to finance expenditures
- Longevity insurance strategy
  - strategy for determining:
    - when longevity insurance is purchased
    - when it comes into effect

Retirement financial strategy

- A good product for delivering retirement income needs to offer:
  - Accessibility
    - degree of flexibility to withdraw funds on an ad hoc basis
  - Inflation protection either directly or via investment performance
    - with minimal involvement by individuals who do not want to manage investment risk
  - Longevity insurance

Retirement financial strategy

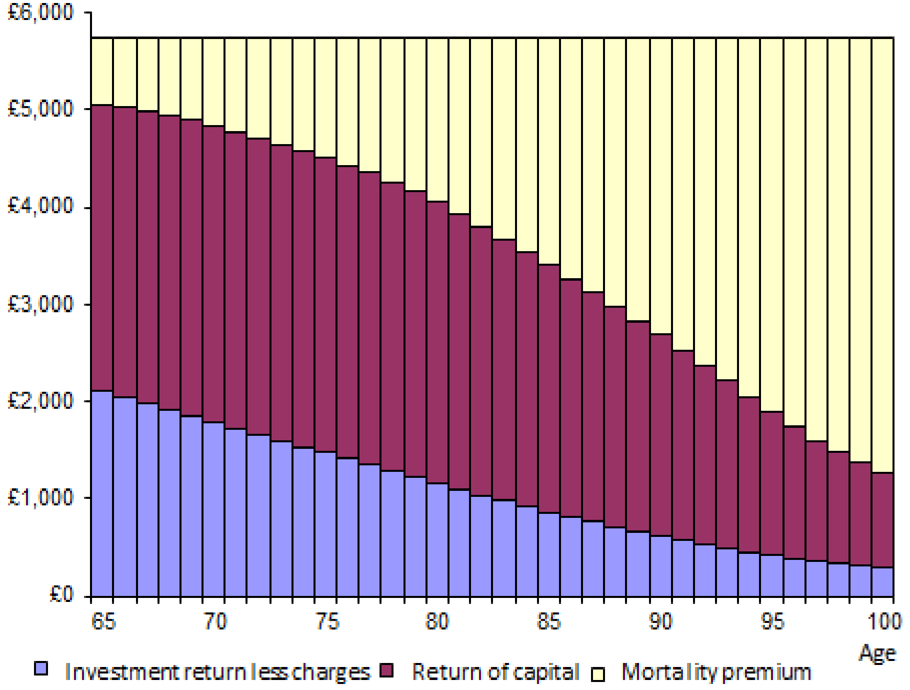
- Difficult for single product to meet all these requirements
- But combination of drawdown and deferred (inflation-linked) annuity does
- So well-designed retirement income programme will have to involve a combination of products

Retirement financial strategy

- Three broad classes of product for delivering the retirement financial strategy:
  - Annuities
  - Drawdown
  - Hybrids
    - combine drawdown and annuities

Retirement income products

Decomposition of annuity payments



Drawdown

- Drawdown has three components:
  - drawdown product where the pension pot is invested
  - arrangement for delivering the pension
    - e.g., self-invested personal pension scheme
  - withdrawal strategy
    - programme for withdrawing funds

- But does not hedge longevity risk

Drawdown

- Multi-asset funds:
  - diversified growth funds
  - multi-asset target return funds
  - multi-asset income funds.
  - AMC < 0.75%
- Multi-manager funds:
  - AMC up to 2%
- In addition to AMC:
  - platform charge of 0.25-0.5% p.a.
  - potential advisory charge of 0.5%-0.75% p.a.

Hybrid products

- Combine drawdown with longevity insurance to provide lifelong income:
  - Drawdown in early years
  - Annuitisation later, via
    - Deferred annuity
    - Reserve fund
    - Gradual purchase

- They are therefore part drawdown and part annuity to differing degrees
  - although this will not be apparent to the consumer for whom an annuity is a ‘bad’ product

Hybrid products

- **Variable annuities**
  - Most common death benefit is return of premium less withdrawals
- **Guaranteed drawdown**
  - Drawdown rate is lower than annuity by 20-30% (e.g., 4% when the annuity rate is 5.5%), but allows more flexibility of access, a guaranteed income and death benefits
  - Annual charge: 1.65-2.5%

Withdrawal strategy

Is there a safe withdrawal rate?

- ***The 4% rule -*** 'safe withdrawal rate' (SWR)?
  - individual can withdraw 4% of fund in first year and same amount adjusted for inflation in subsequent years
- If individual prepared to accept a 10% probability of failure, SWR increases to 4.17%
  - 10% chance of running out of money before 30 years
- 5% withdrawal rate results in failure probability of 27.5%

Is there a safe withdrawal rate?

- Involves taking out a fixed (albeit index-linked) amount whatever market conditions:
  - leaves open possibility of both over- and under-spending
- Ignores longevity risk
- Ignores fund management charges
- Ignores ‘sequence-of-returns’ risk
- Conclusion: NO SAFE FIXED WITHDRAWAL RATE!

Is there a safe withdrawal rate?

- **Alternatives to the 4% rule which dynamically adjust withdrawals to market conditions:**

- Withdraw annuitised value of the fund
  - known as ‘equivalent annuity’ strategy
- With this strategy, retirees will never run out of money before they die

Is there a safe withdrawal rate?

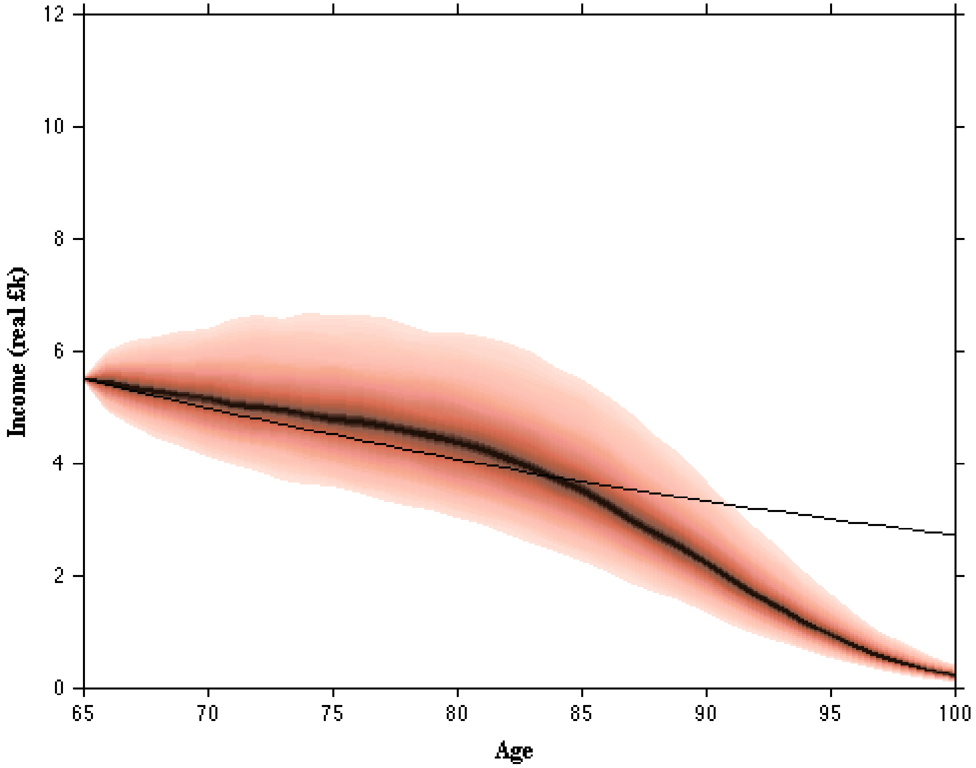
- Draw only ‘natural’ income from the fund
  - defined as the ‘pay-out of dividends from income-generating investments’
- Auto-rebalancing
  - withdraw from asset classes that experienced highest growth during year
- Cashflow reserve (or bond) ladder or bucket
  - hold enough in deposits or short-maturing bonds to meet next two years of expenditure

Longevity insurance strategy

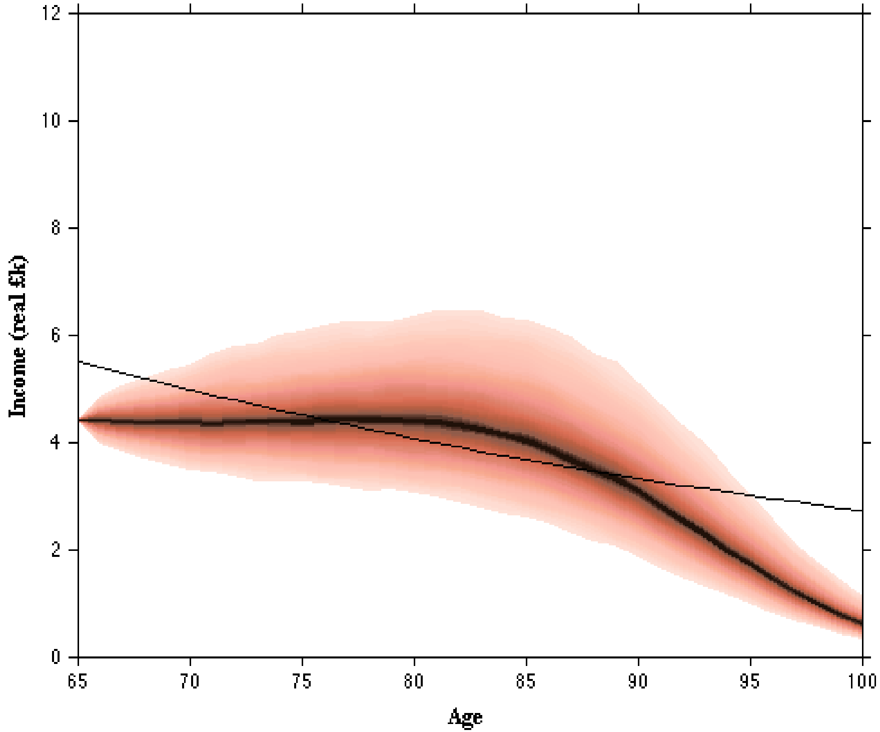
Longevity insurance strategy

- Determines:
  - when longevity insurance is purchased
  - when it comes into effect
- Essentially boils down to the choice between:
  - buying immediate annuity when it is needed, and
  - buying deferred annuity at point of retirement
    - with deferred annuity beginning to make payments when it is needed

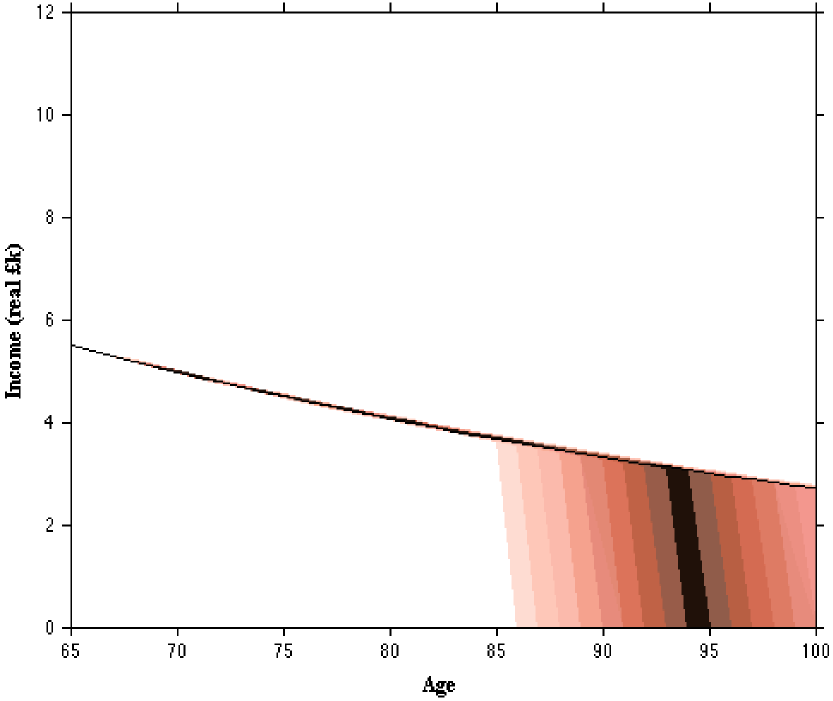
Distribution of real income with 100 % drawdown and no deferred annuity



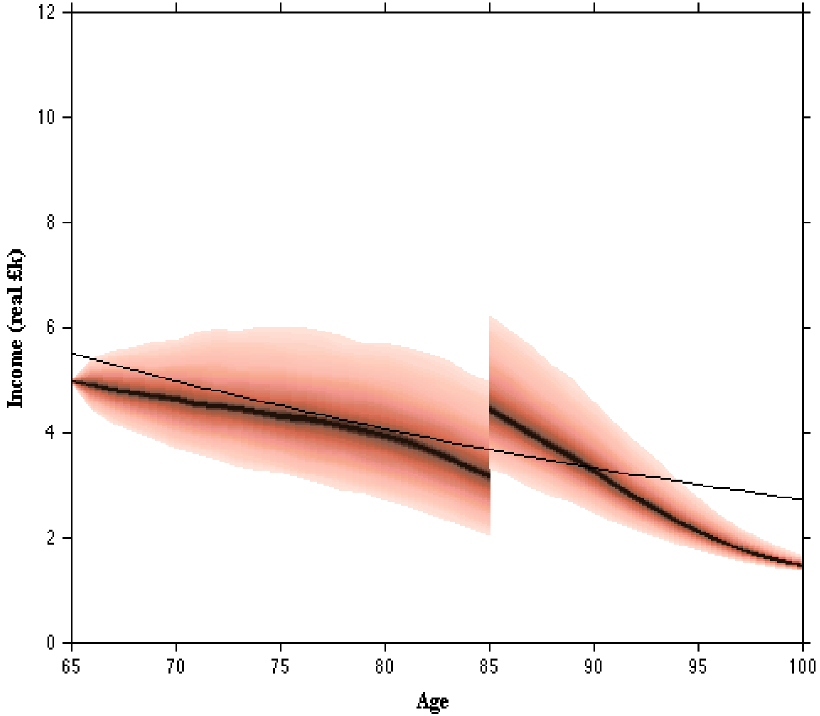
Distribution of real income with 80% drawdown and no deferred annuity



Distribution of real income with a fixed amount withdrawn each year equal to 100% of the initial annuity amount



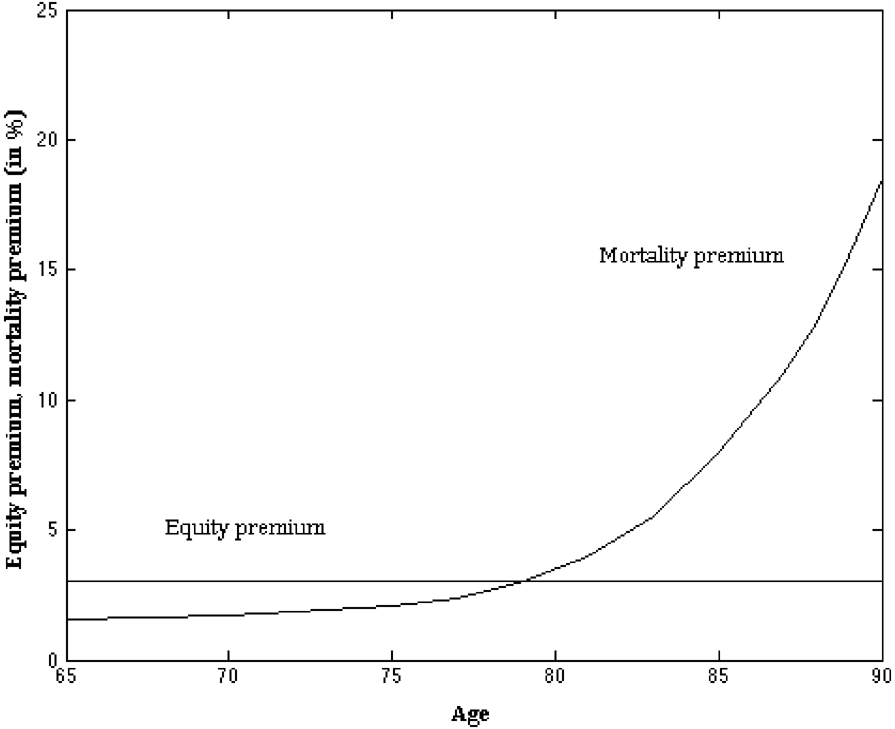
Distribution of real income with 100% drawdown and 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85



Longevity insurance strategy

- What these Figures strikingly demonstrate is the two key unavoidable tradeoffs people need to make:
  - higher income earlier in retirement or higher income later (and vice versa), and
  - higher overall lifetime income from an annuity against the extra flexibility and death benefits available with drawdown
- Ultimately, optimal decision comes down to choosing what risk of a reduction in future lifetime income a retiree is prepared to accept for retaining control over their assets.

Milevsky switching rule



Default retirement income/expenditure plan

Defaults and default pathways

- Experience of auto-enrolment in accumulation suggests that only way default will work for mass market is if people automatically enrolled during pre-retirement guidance or advice surgery
  - ideally arranged through employer, pension provider or following a discussion with financial adviser

- Everyone would have the right to opt out at any time

Defaults and default pathways

- For all individuals, collect information on:
  - Pension pot size
  - Other sources of lifelong income (state and DB pension)
  - Other sources of wealth (e.g., housing equity)
  - Liabilities (e.g., mortgage, credit card debts)
  - Health status
  - Family circumstances, including bequest intentions
  - Given other income sources, health status and family circumstances, decide the levels of expenditure that are considered ‘essential’, ‘adequate’ and ‘desirable’
  - Tax position
  - Risk attitude and capacity

Defaults and default pathways

- Given this information, the following default pathway can be established:
- Given total assets and liabilities, decide whether to use part of the fund to pay off any debts
  - e.g., mortgage
- Decide how to fund ‘essential’ life-long expenditure:
  - only secure way of doing this is via index-linked lifetime annuity or guaranteed drawdown offering inflation uprating
    - if essential really means ‘essential’
    - unless member is single and in extremely poor health

Defaults and default pathways

- Decide on:
  - level of insurance to cover contingencies or
  - alternatively size of ‘rainy day’ fund
    - and in what type of liquid investment this will be held

Defaults and default pathways

- Decide how to fund ‘adequate’ expenditure needs
- Two possible solutions:
  - For those wanting absolute guarantee
    - annuitise another segment of the pension pot via:
      - capital protected, inflation-linked, fixed, investment-backed, variable or enhanced annuity
  - For those who want more flexibility and prepared to reduce expenditure if investment performance is poor
    - use drawdown programme invested in:
      - e.g., income fund or guaranteed drawdown

Defaults and default pathways

- Decide how to fund ‘desired’ standard of living and make planned bequests
- Depending on risk attitudes, the investment is likely to be a ‘diversified growth fund’
  - with drawdown as and when required
- To ensure that that they are met on a life-long basis, residual pension would need to be annuitised at some stage

Defaults and default pathways

- Three ways of doing this:
  - use percentage of pension pot (e.g., 10%) to buy deferred annuity coming into force at say 75 or 80
    - if the plan member lives that long
  - pay for deferred annuity in monthly instalments
    - deals with behavioural problem of giving up capital sum
  - hold a reserve fund which is used to buy an annuity at age 75 or 80
- Guaranteed drawdown is again an alternative to annuitisation

Defaults and default pathways

- Decide on any further annuitisation to reduce the variability around the level and timing of any desired inheritance:
  - e.g., into voluntary life annuity or immediate-needs annuity to cover long-term care costs

SPEEDOMETER (or Spending Optimally Throughout Retirement) retirement expenditure plan

- First, make a plan:
  - via auto-enrolment, guidance or advice
- Second, secure ‘essential’ income:
  - managing all assets and income sources to secure core inflation-protected income to meet ‘essential’ needs for rest of life
- Third, have insurance and a ‘rainy day’ fund to cover contingencies.
- Fourth, secure ‘adequate’ income
- Fifth, achieve a ‘desired’ standard of living and make bequests

Advantages of defaults

- Deals with reluctance of people to annuitise
  - Pension death benefits are generous for income drawdown
    - not for annuities
  - Phasing into annuitisation may be more acceptable

- Deals with reluctance to pay for advice

Safe harbour status

Recommendation 1: Criteria for granting safe harbour status to key retirement income products

- We recommend that regulators agree a set of criteria for granting safe harbour status to key retirement income products
- Providers and advisers could not subsequently be sued for offering or recommending a safe harbour product
  - having first determined its suitability for a client as part of a safe harbour retirement income plan
- As part of the process of product regulation, a product rating service should be established to assess whether products satisfy the minimum standards

Recommendation 2: Safe harbour retirement income plan

- We recommend that a quasi-default retirement income plan is designed and used by providers and advisers
- This will involve a simple decision tree and a limited set of default pathways
- The plan would be self-started following a guidance or advice surgery
- The plan member has the right to opt out
  - until the point at which longevity insurance kicks in
- Any adviser or provider making use of such a retirement income plan would be protected against future mis-selling claims

Recommendation 2: Safe harbour retirement income plan

- The plan could be operated by a provider or an adviser
- Two forms of the plan would be acceptable:
  - drawdown plus a deferred annuity, or
  - layering – first secure essential life long expenditure ('heating and eating'), then allow for luxuries.
- The plan must allow for:
  - access – flexibility to withdraw funds on ad hoc basis
  - inflation protection (either directly or via investment performance), and
  - longevity insurance

Modelling outcomes and establishing value for money

Recommendation 3: Modelling outcomes for different retirement income products

- In terms of modelling outcomes, we recommend that:
  - The use of deterministic projections of the returns on products should be banned
  - They should be replaced with stochastic projections that take into account important real world issues, such as:
    - sequence-of-returns risk
    - inflation risk
    - transactions costs in dynamic investment strategies

Recommendation 3: Modelling outcomes for different retirement income products

- There should be a commonly agreed parameterisation for the stochastic projection model used
  - i.e., a ‘standard model’ should be developed
- There should be a commonly agreed set of good practice principles for modelling the outcomes from retirement income products

▪ As in the case of Solvency II, product designers would be free to use an ‘internal model’

- so long as they explained the differences between this and the standard model.

Recommendation 4: Establishing a metric for measuring product value for money

- We recommend that the regulator establishes a metric for measuring product value for money that would:
  - Have credibility and transparency
  - Avoid room for gaming the process
  - Be clear, simple, difficult to dispute and difficult to manipulate
  - Reflect key risks

Recommendation 4: Establishing a metric for measuring product value for money

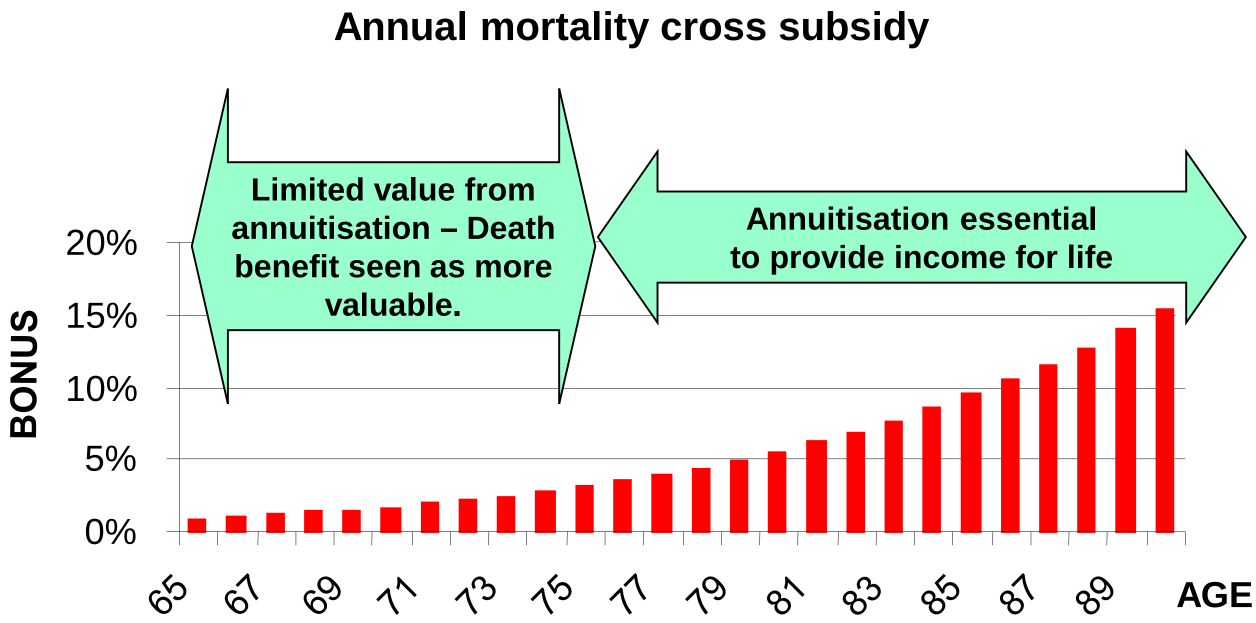
- An example of such a metric would be the ‘money’s worth’ (MW) of a product:
  - ratio of the expected present value of payouts on the product to the price
  - with due allowance made for the greater flexibilities of some products in terms of accessibility and death benefits
- Similarly, the risk of drawdown products could be expressed in terms of a potential shortfall relative to an annuity

Conclusions

Conclusions

- Decumulation investment strategies are VERY different from accumulation investment strategies
- Hedging longevity risk becomes THE single most important consideration
- Interest rate and inflation risks are also important
- Investment considerations are relevant for those with sufficient assets or who are genuinely risk tolerant
- Need default pathway to deal with this
- BUT: no market in deferred annuities

Not if, but when to annuitise!



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Thank you!