Default retirement income strategy

Lessons from the UK

David Blake

Independent Яeview of Retirement Income

www.pensions-institute.org

d.blake@city.ac.uk

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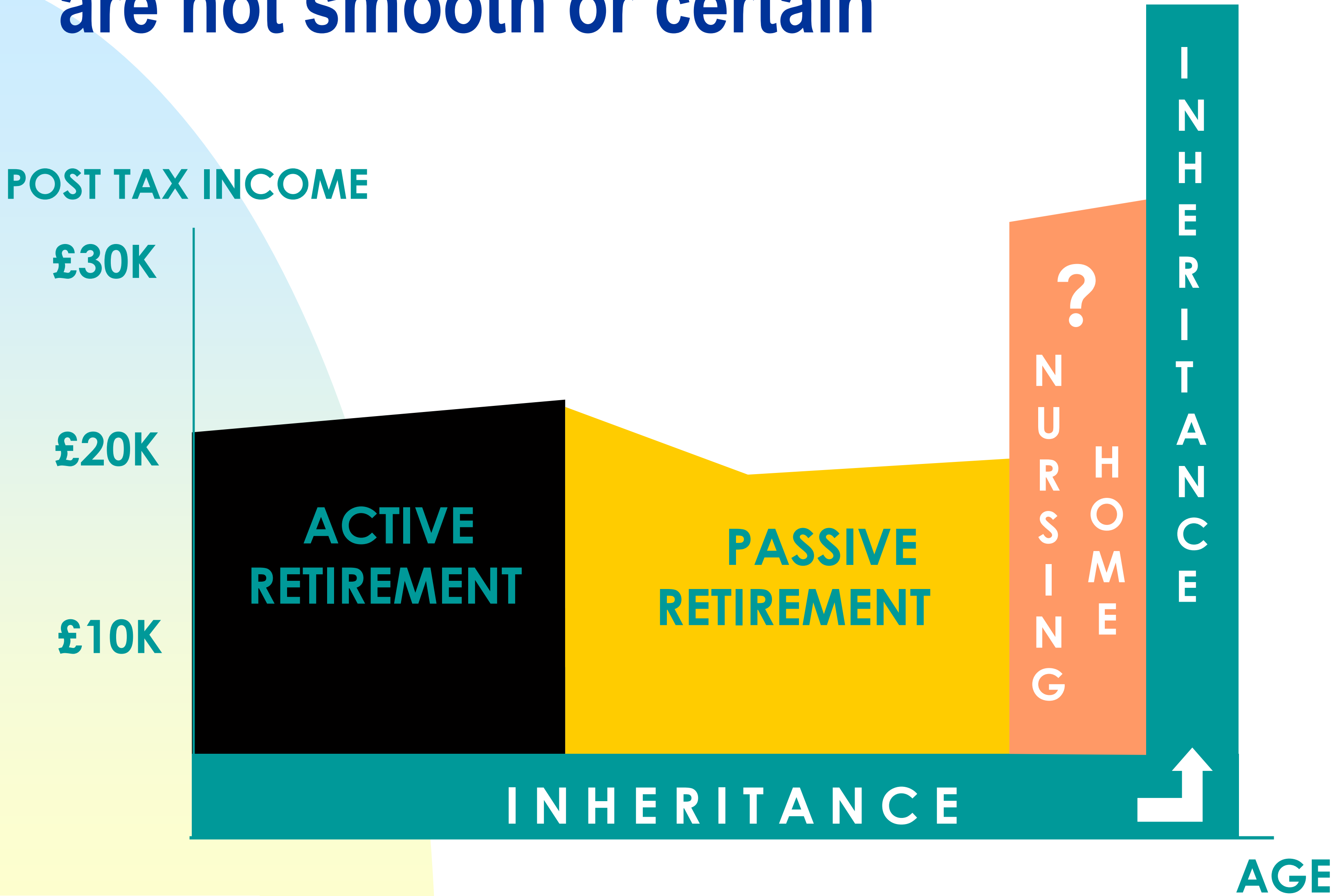
Agenda

- Needs and risks in retirement
- Retirement income planning
- Retirement financial strategy
- Retirement income products
- Withdrawal strategy
- Longevity insurance strategy
- Default retirement income/expenditure plan
- Conclusions

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
- 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 – no risk pooling

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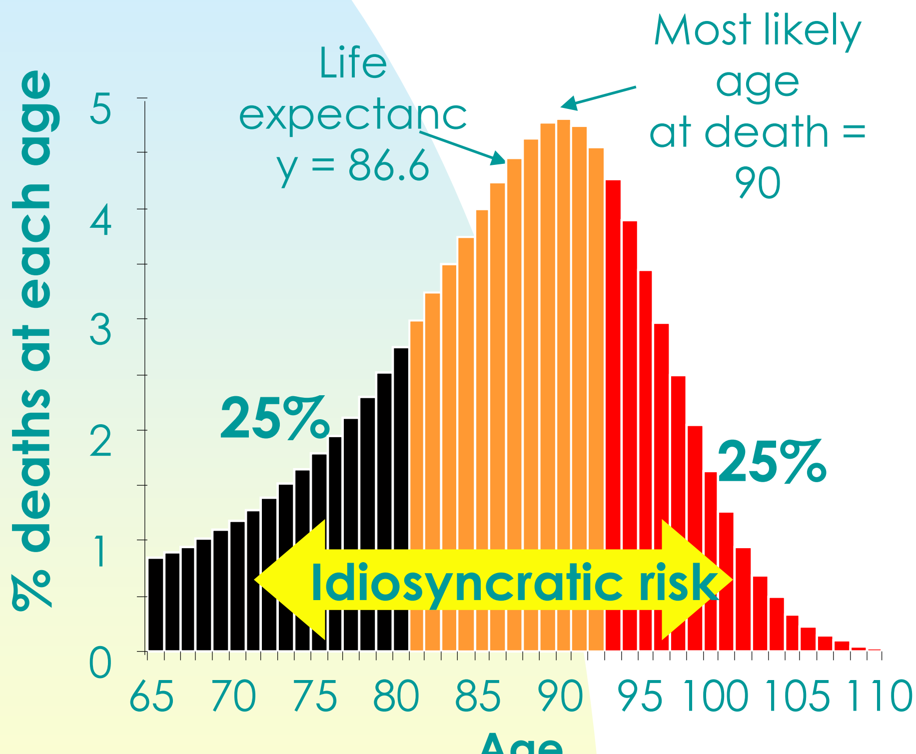
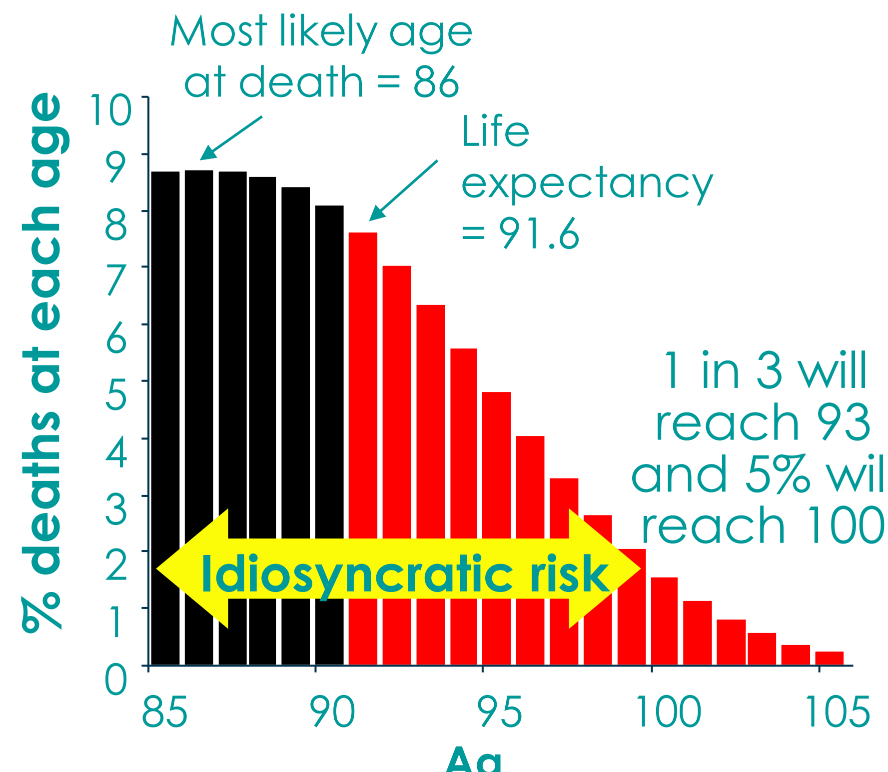
Variability in life expectancy

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

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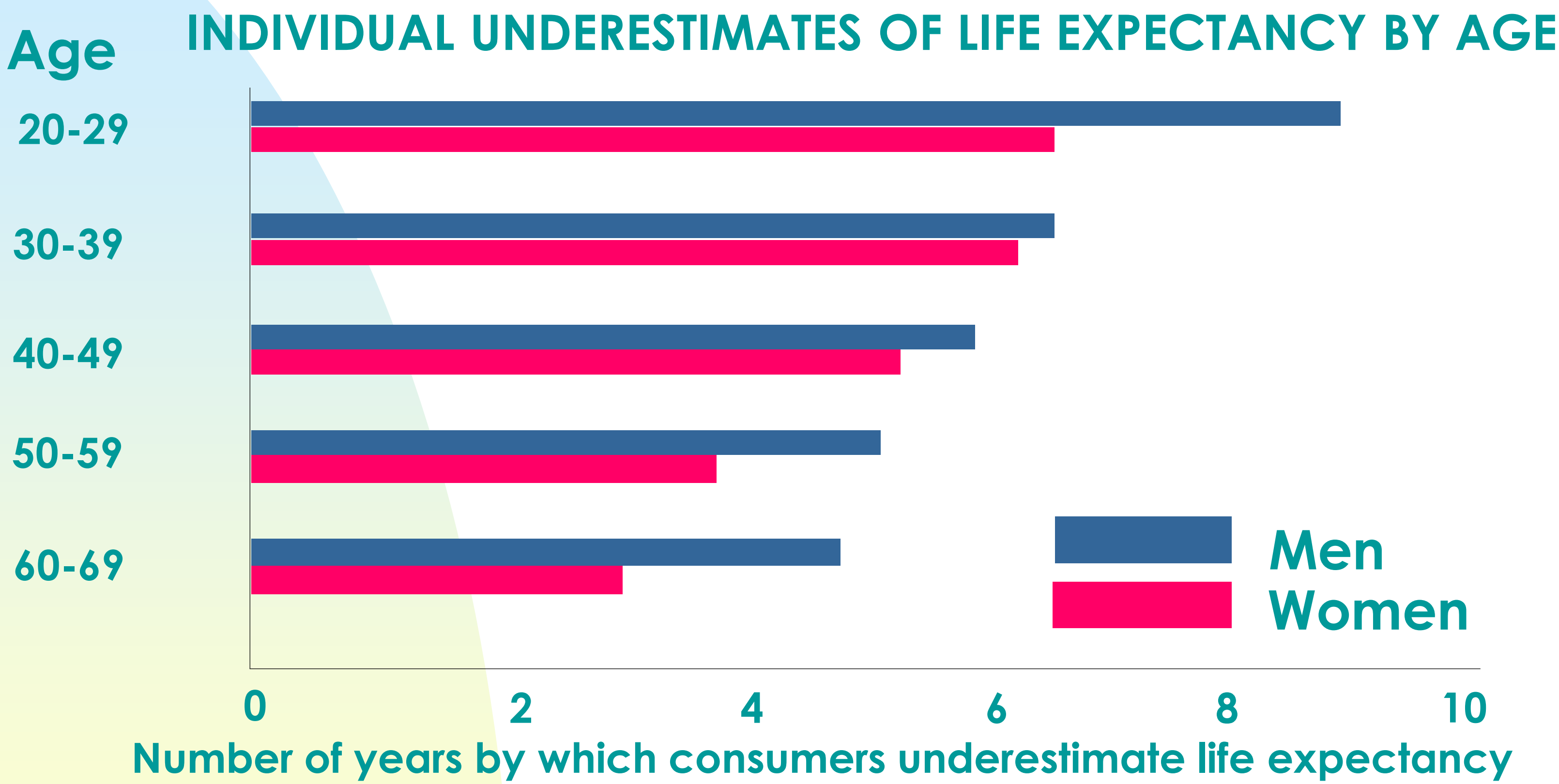
Source: 100% PNMA00 medium cohort 2007

Individuals consistently underestimate how long they will live...



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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

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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 and when it comes into effect.

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

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Retirement financial strategy

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

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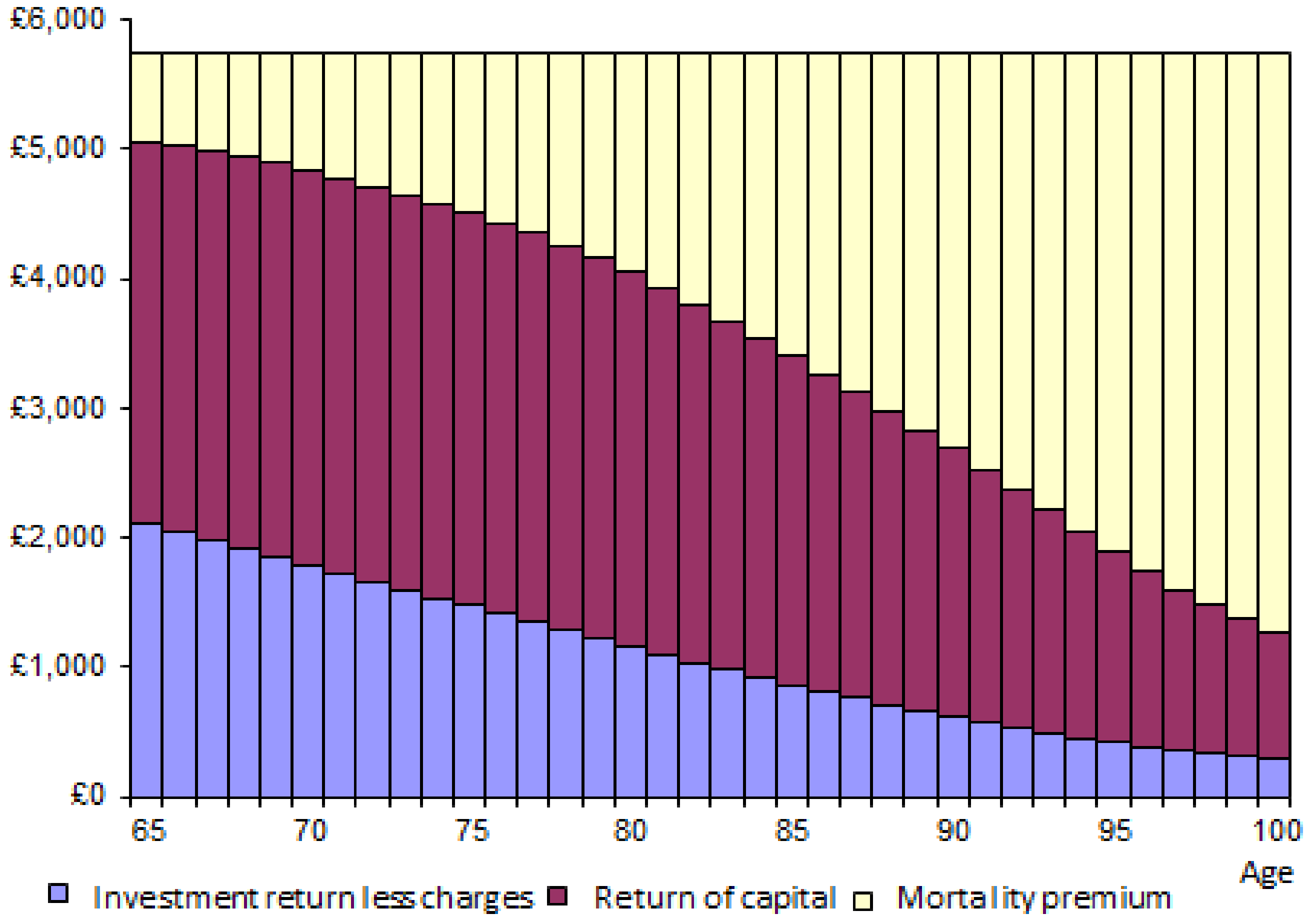
Retirement income products

Decomposition of annuity payments



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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

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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)?
- 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 and 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

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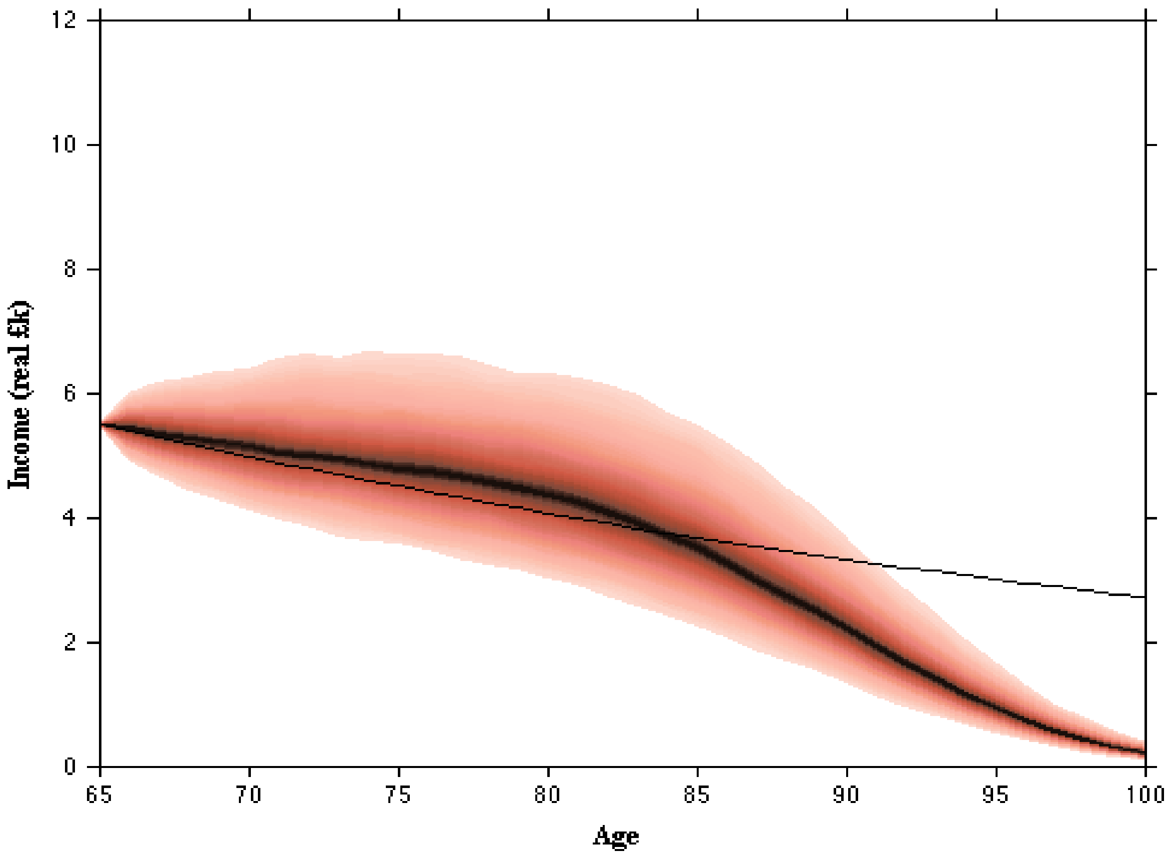
Distribution of real income with 100% drawdown and no deferred annuity



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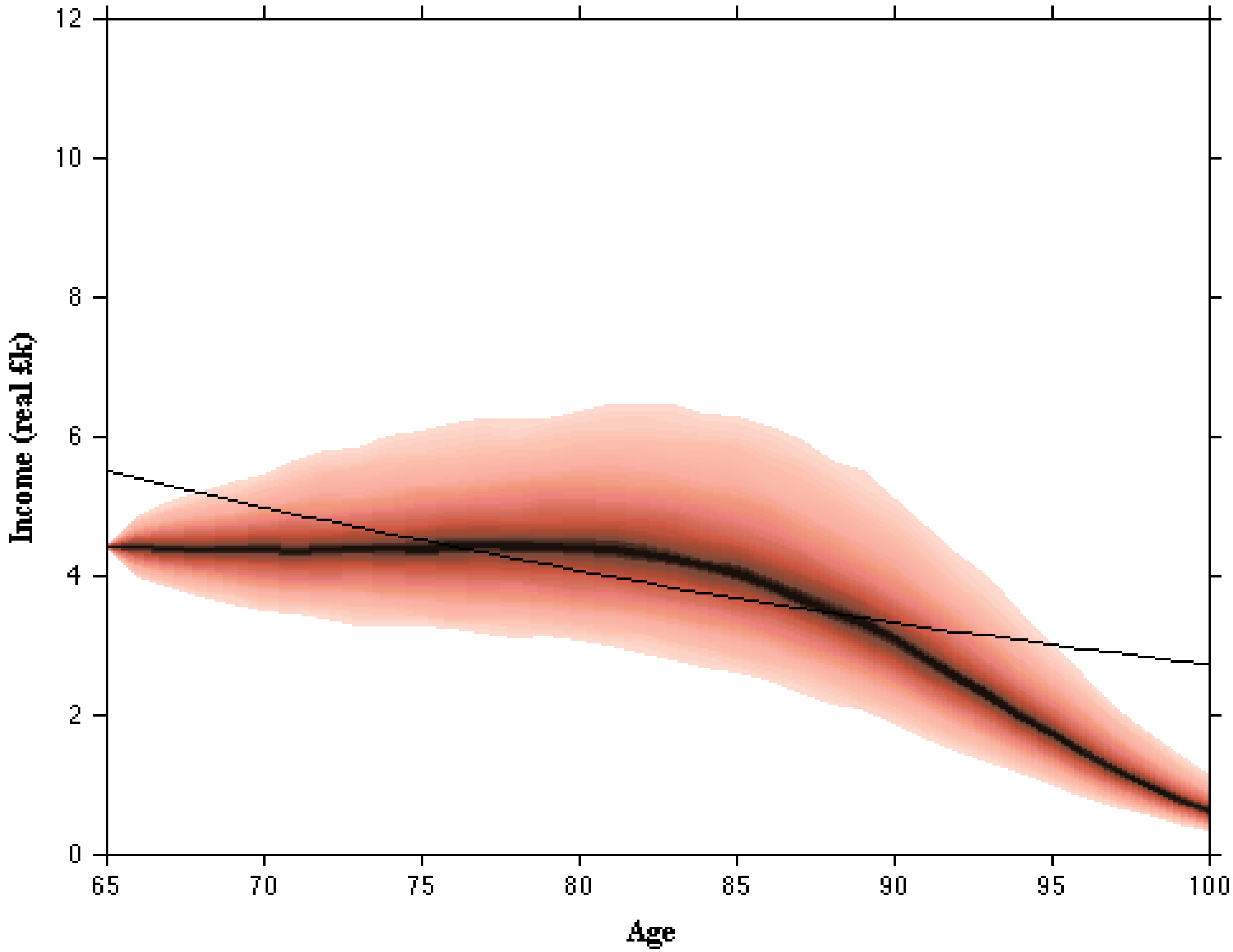
Distribution of real income with 80% drawdown and no deferred annuity



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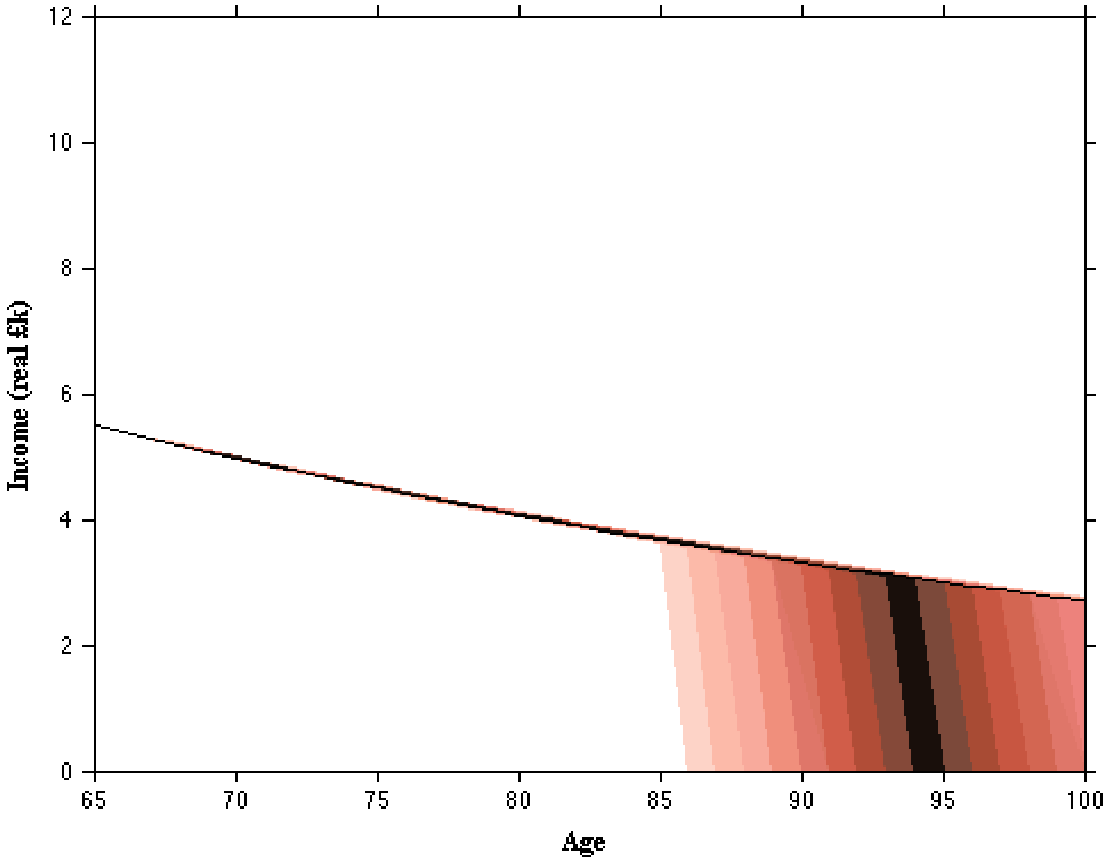
Distribution of real income with a fixed amount withdrawn each year equal to 100% of the initial annuity amount



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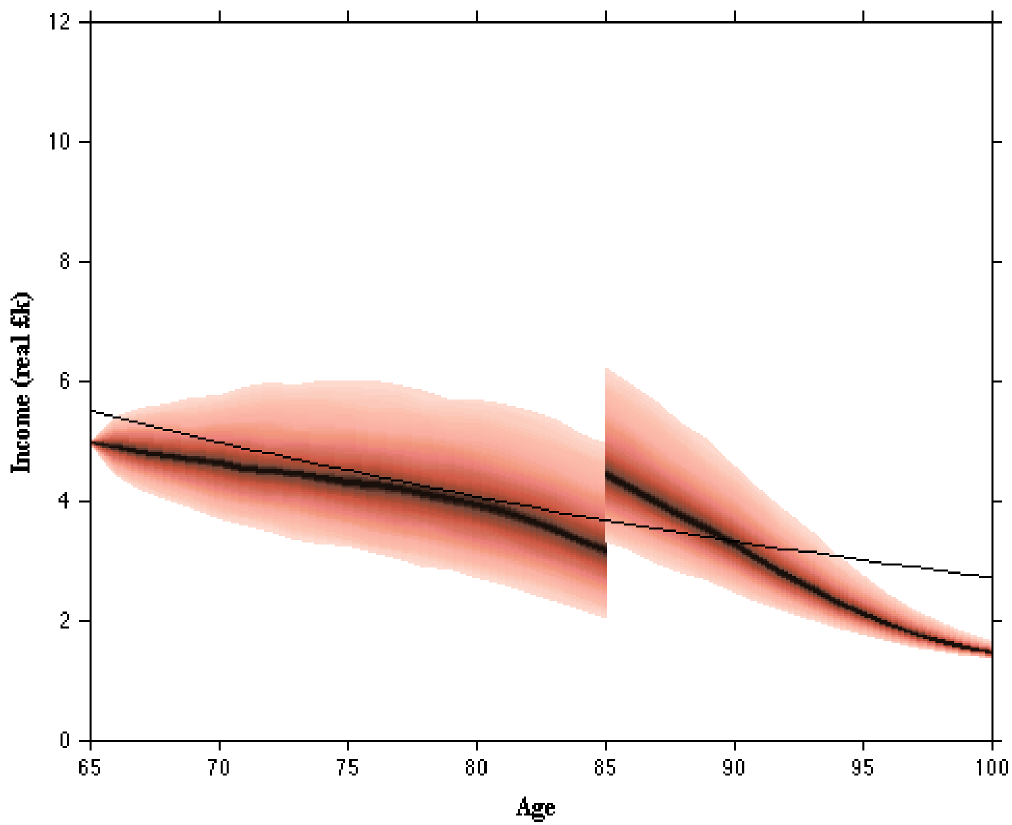
Distribution of real income with 100% drawdown and 10% of the fund used at age 65 to purchase a deferred annuity that starts paying at age 85



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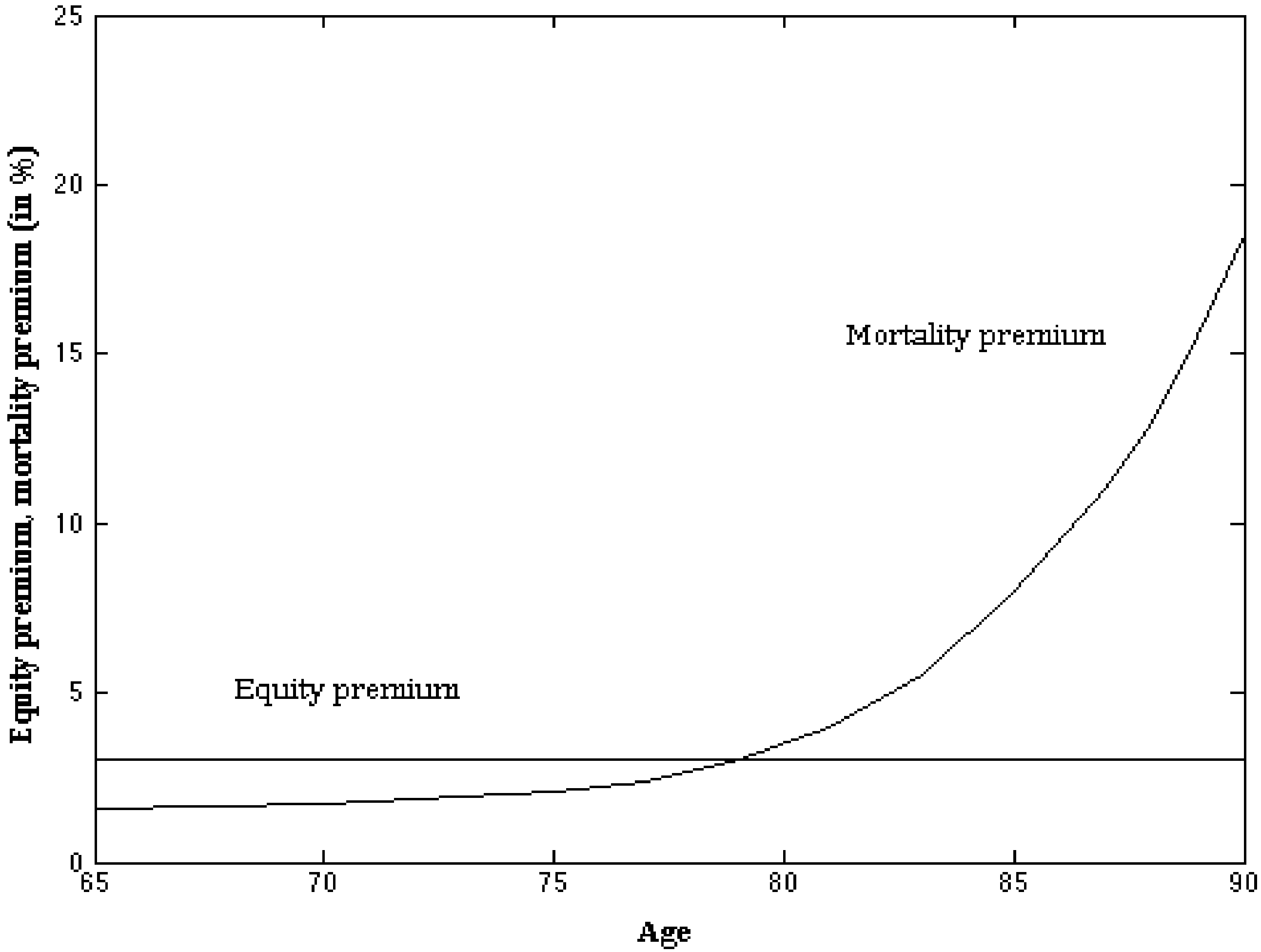
Milevsky switching rule



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 into 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

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

Recommendation 3.1: 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

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Recommendation 3.1: 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

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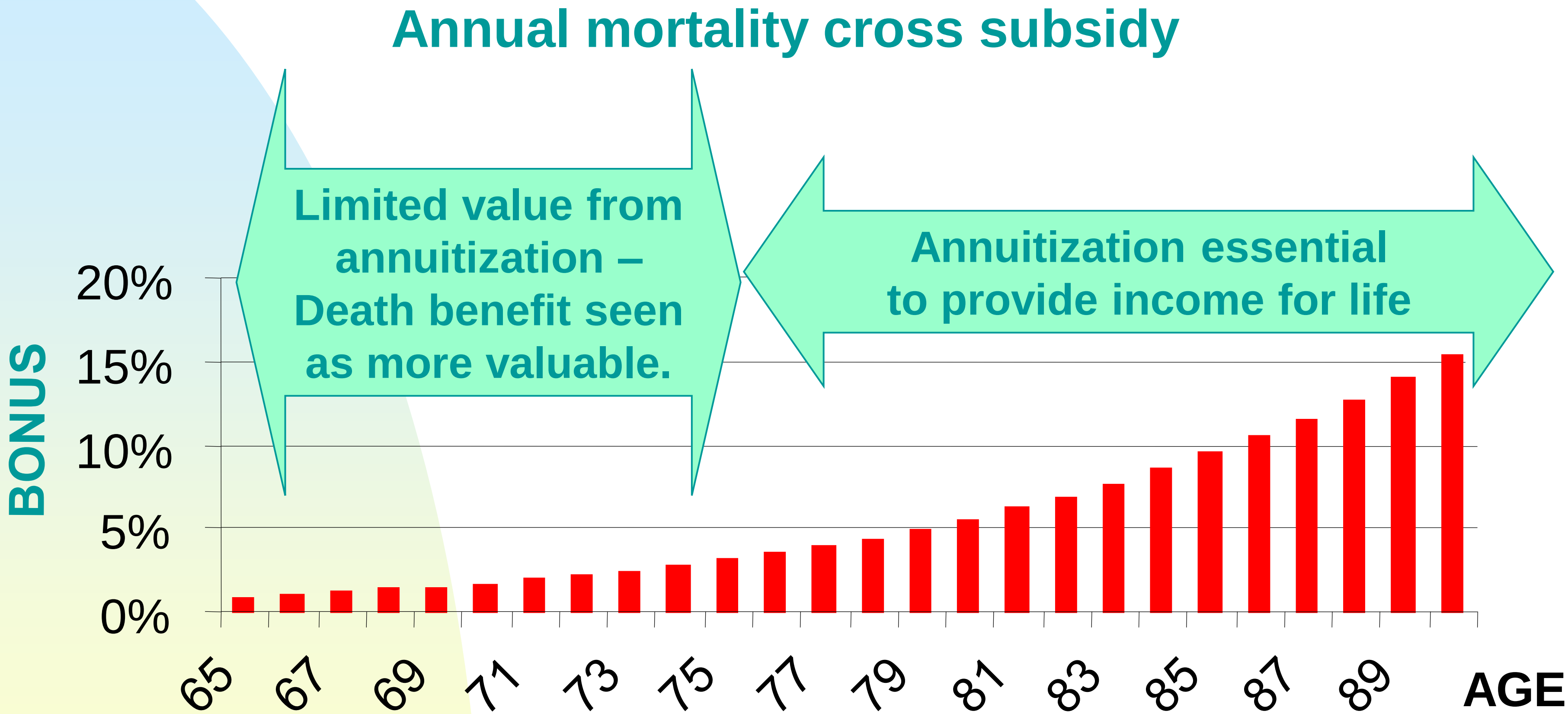
Conclusions

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

Not if, but when to annuitize?



Thank you!