



Distribution of Retirement Solutions in the 'At Retirement' Market

Spend More Today: Using Behavioural Economics to Improve Retirement Expenditure Decisions

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Outline of presentation

- Needs, risks and financial resources
- Optimal solutions
- Behavioural barriers
- Choice architecture and nudges
- Conclusions

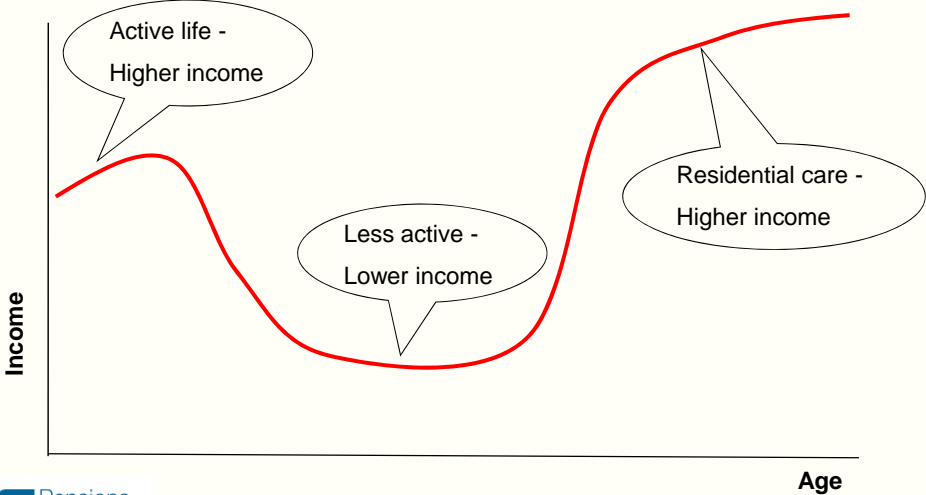




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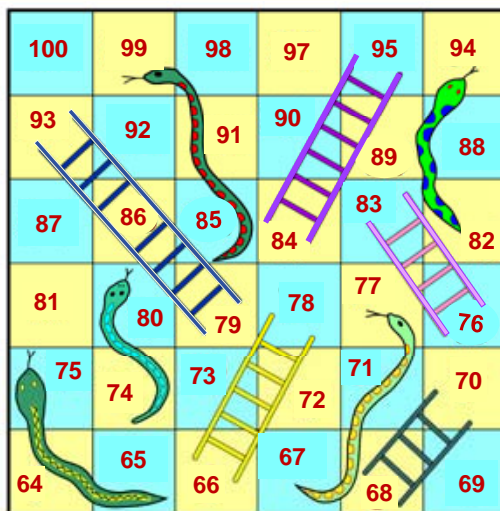
Needs, Risks and Financial Resources

Income needs in retirement are not smooth or certain



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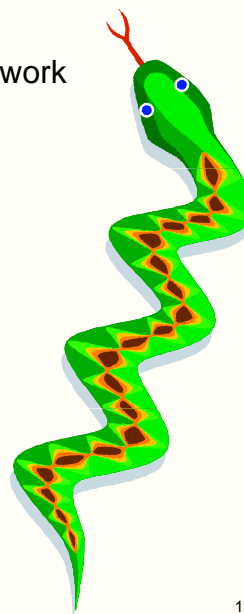
Living through retirement can be a bit like snakes and ladders ...



- There are many events that can impact even a well structured retirement income plan
- Many are unpredictable and essentially random or at least the time of their occurrence is random

There are many snakes ...

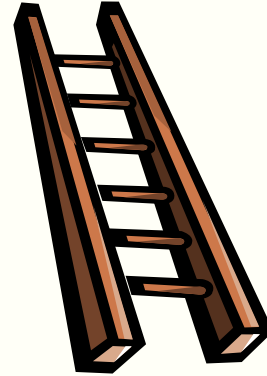
- Loss of or inability to find post-retirement work
- Poor investment returns
- Periods of high inflation
- Changes in taxation and benefit rules
- Failure of private pensions
- Unexpected needs of dependants
- Divorce
- Ill health
- Death of a spouse
- Funding for long-term care



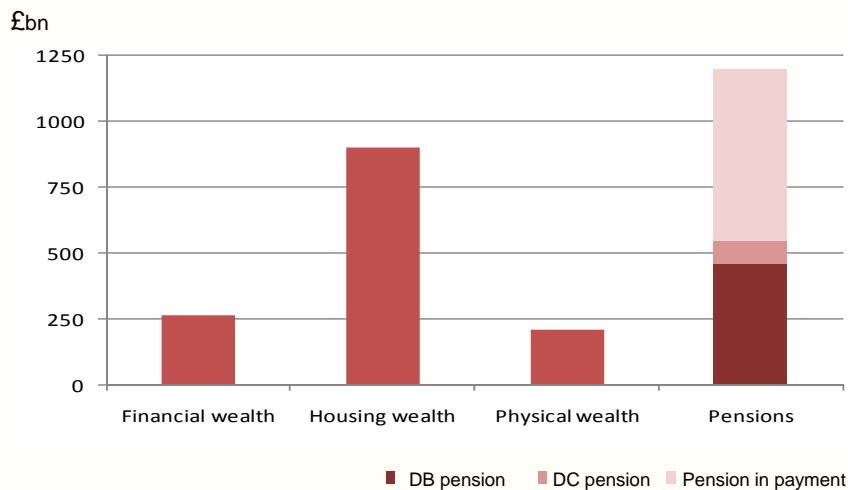
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Regrettably there are fewer ladders ...

- Part-time working
- State benefits and allowances
- Inheritance from elderly parents
- Lower inflation
- Higher investment returns
- Marriage
- Opportunity to use housing equity



Total wealth for ages 55 to 64 in 2005





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Retiree segmentation 50+ pre-retirement

- **Low Affluent**
 - 3 million (35%)
 - Net income below £10,000
 - Mean financial wealth £2,200
- **Mass Market**
 - 4 million (45%)
 - Net income between £10,000 and £30,000
 - Mean financial wealth £13,300
- **Mass Affluent and High Net Wealth**
 - 1.8 million (20%)
 - Net income above £30,000
 - Mean financial wealth £71,400

Source: Analysis of FSA Baseline Survey of Financial Capability (2006) by Jackie Wells

Optimal Solutions

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Retirement income planning is inevitably about trade offs

Personal circumstances will influence the right decisions for an individual

- 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

Key option is the trade off between death benefit and income

An annuity is the best option for most of the mass market ...

- Most pensioners have limited means
- Likely to have to accept a relatively simple strategy with default options
- Primary focus will be on maximizing retirement income
- Level annuity may be appropriate given size of fund, inflation protection of state benefits and shape of the income need curve
- Likely to have to rely on the state and any housing equity for providing for their health care and other retirement contingencies
- Bequests - mainly in the form of residual housing equity - are typically left more by chance



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Optimization for the mass affluent is very complex

- Very difficult task to optimize the controlled run down of a pensioner's assets
- Retirements of 20 years or more
- Decumulation investment strategy far more complex than accumulation
- Mass affluent need to take account of inflation risk
- Varying needs and risks
- Optimal solutions are likely to differ

The optimal solution in early retirement is generally to retain flexibility with some downside insurance

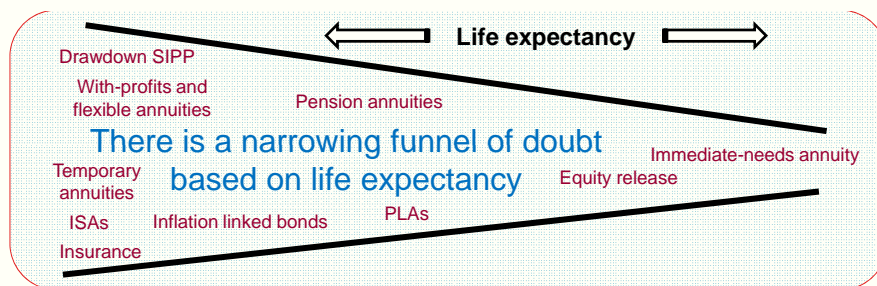
Given the doubts and uncertainty in early years of retirement:

- Generally makes sense for pensioners with sufficient wealth to retain flexibility and control
- Pensioners should look to secure a base income, and ...
- Use insurance solutions to reduce the uncertainty from adverse events
- Key role for home ownership and equity
- Annuities have a role to play as life expectancy reduces

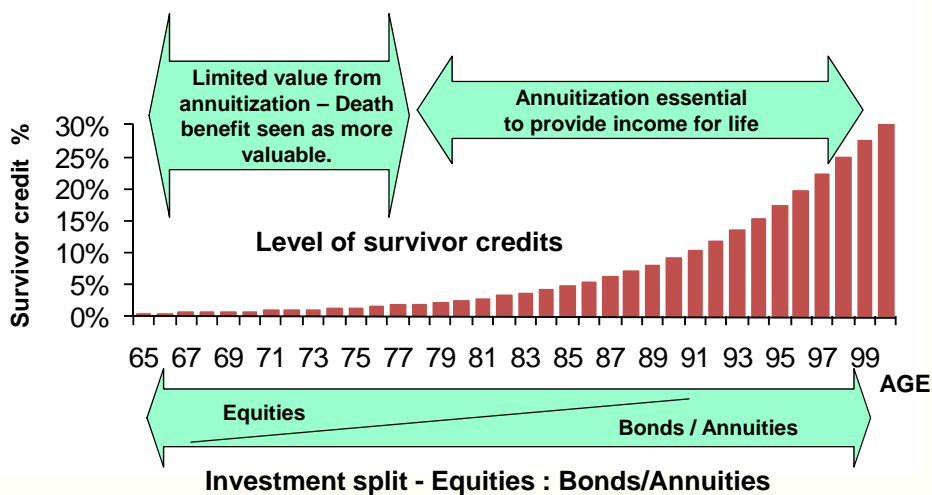
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As life expectancy reduces optimization becomes easier ...

- Fewer risks to cater for
- Investment considerations become easier
- Income expenditure less volatile when people enter care homes



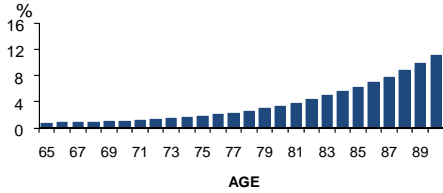
It is not a question of IF but WHEN pensioners should annuitize



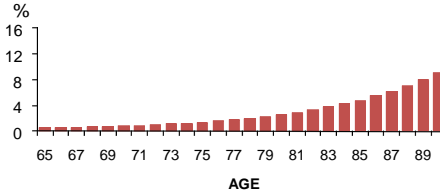
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Optimal age to annuitize is later for females and couples

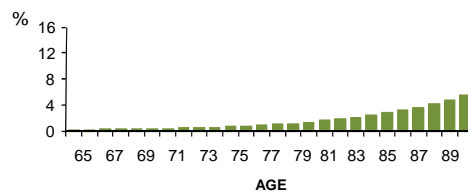
Survivor credit
Male life aged 65



Survivor credit
Female life aged 65



Survivor credit - Joint lives aged 65



Behavioural Barriers



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Behavioural economics ...

- Behavioural economics combines economics, finance, psychology and sociology
- Standard economic theory fails to take human behaviour into account
- Richard Thaler and Cass Sunstein¹ define two types of consumers:
 - 'Econs' who are highly rational consumers
 - 'Humans' who are subject to behavioural traits that limit their ability to implement their intended financial plans
- Thaler and Sunstein believe that few people are 'Econs'
- Most of us are 'Humans' and we need 'nudges'

Rational for mass affluent not to annuitize

- Wealth
- Flexibility
- Bequests
- Inflation risk
- Money's worth
- Ad hoc expenditure
- Couples
- Phasing

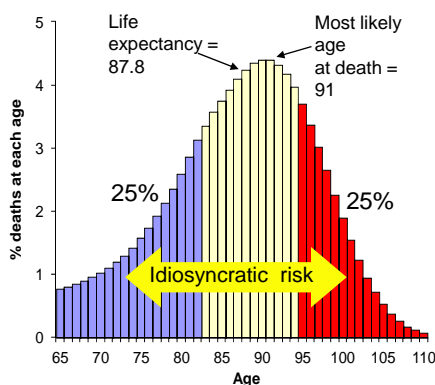
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“Humans” are poorly equipped to take rational actions

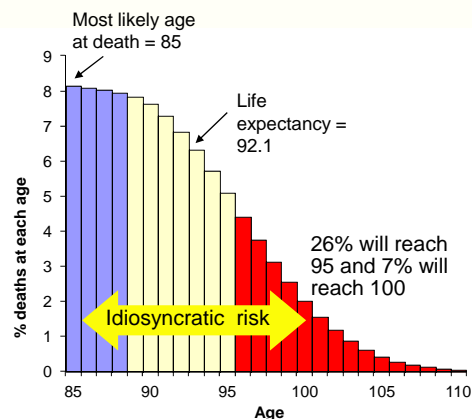
- Poor financial literacy
- Poor understanding of effects of inflation
- Poor at estimating life expectancy
- Poor understanding of the variability of actual lifetimes

Consumers don't understand variability in life expectancy

Expected distribution of deaths: male 65



Expected distribution of deaths: male 85



Source: 100% PNMA00 2010 plus improvements in-line with CMI_2009_M [1.00%]

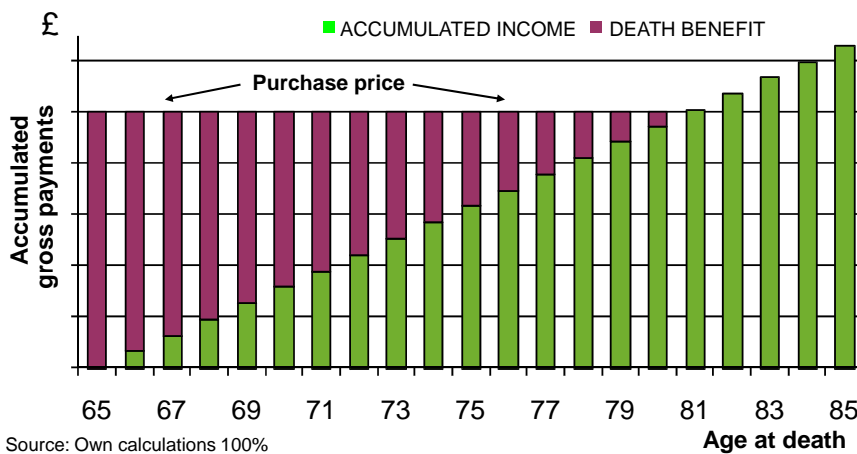
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'Humans' have behavioural traits that limit their ability to take rational actions

- Choice, inertia and procrastination
- Aversions to:
 - planning
 - large long term transactions
 - losing control
 - dealing with complex problems
 - paying for advice
 - making losses and taking risks
- Framing, herding and norming
- Overvalue the present and undervalue the future
- Over-estimate the probability of low-probability events and underestimate the probability of high-probability events

Death benefits under a money-back annuity

On death any excess of the original purchase price over the gross annuity payments already received is returned to the annuitant's estate



Source: Own calculations 100%
PNMA00 2010 plus improvements
in-line with CMI_2009_M [1.00%]



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These behaviours lead to ...

- Overconfidence and self-control problems
- A tendency to over consume today and so face the possibility of running out of retirement assets before they die
- Failure to plan
- No sense that an annuity is a smart thing to buy
- Sub-optimal decisions
- Solution is to 'nudge' them towards making decisions that improve their welfare (or use compulsion!)

Choice Architecture and Nudges



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SPEEDOME *TER* retirement expenditure plan

Spending Optimally Throughout Retirement

- **First**, make a plan
- **Second**, secure 'essential' income
- **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

A universal plan for all retirees

First, make a plan

- Either ... by using an on-line or telephone-based service providing generic financial advice
- Or ... if wealth permits, involving a financial adviser whose role is to assist with making and implementing the plan and conducting annual reviews



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Second, secure 'essential' income

- Plan manages **all** assets and income sources holistically to secure essential income
- Defined as the **minimum**, core inflation-protected income sufficient to meet the retiree's 'essential' needs for the remainder of their (and their spouse's) life.

Third, have insurance and a 'rainy day' fund to cover contingencies

- Use insurance solutions, when available and cost effective, to cover contingencies,
- Where appropriate, rely on state support
- Where possible, maintain flexibility by holding sufficient assets to meet uninsurable shocks (i.e., a 'rainy day' fund)



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Fourth, secure 'adequate' income

- Secure an 'adequate' level of life-long income above the minimum if there is sufficient wealth
- 'Adequate' income defined as that needed to achieve the minimum lifestyle to which the pensioner aspires in retirement.

Fifth, achieve a 'desired' standard of living and make bequests

- The plan uses a simplified choice architecture for managing any residual wealth
- Aim of achieving a 'desired' standard of living in retirement, while allowing part of the remaining wealth to be bequested at a time of the retiree's choosing.



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How a **SPEEDOME TER** plan deals with behavioural traits

- Use of inertia and procrastination
- Use of defaults
- The plan **NOT** the member deals with complexity of decumulation
- Use of commitment devices
- Use of money back annuities
- Use of phasing
- Positive norming via effective communication
- The slogan 'spend more today' to reinforce the idea that 'buying an annuity is a smart thing to do'.

Conclusions



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The **SPEEDOMETER** plan involves just four key behavioural nudges:

- First, make a plan
- Automatic phasing of annuitization
- Capital protection in the form of 'money-back' annuities
- The slogan 'spend more today' to reinforce that 'buying an annuity is a smart thing to do'.

Spend More Today: Using Behavioural Economics to improve Retirement Expenditure Decisions

David Blake & Tom Boardman

www.pensions-institute.org/workingpapers/wp1014.pdf