The Future of (At) Retirement

July 2018

Empower Results®

Introduction

The title of this short paper is deliberately clumsy. We are not asking whether retirement itself is an outdated concept that needs to be retired – a subject deserving of a paper in itself. Rather we are discussing here what is happening now, and needs to happen in the near and medium term, in the 'at retirement' market. What products, processes and guidance do we need now, and in the future, to deal with the challenge of spending our defined contribution (DC) savings pots – the ugly decumulation word.

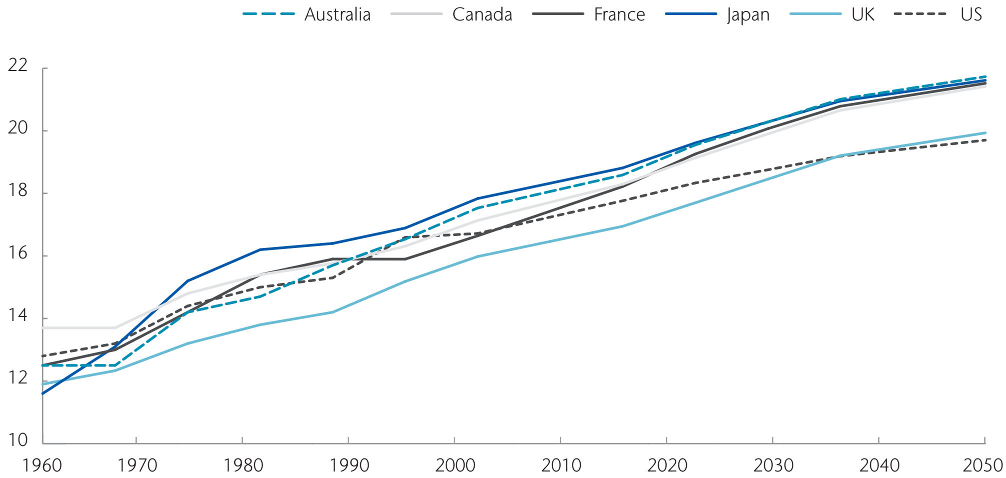
This is a global challenge – all of the major DC countries around the world are grappling with this issue. Our research and work with our Aon colleagues worldwide leads us to the conclusion that there is no silver bullet solution out there.

However, there are actions that can be taken now to enhance the current position, so read on!

The challenge of decumulation

So why is decumulation such a difficult issue, that nobody has cracked worldwide? The challenge is a big one. Conventional annuities worked well to provide a guaranteed stable income for a relatively short number of retirement years. The massive improvements in longevity mean that lifetimes in retirement are now significantly longer, and bond-backed annuities are unlikely to generate sufficient investment returns to support this extended period. Life expectancy has increased by about three months a year since 1840. Successive poor winters have led to a reduction in the pace of improvement in longevity in the UK – but it is only a slower rate of increase, rather than a decrease. We need to face up to the prospects of much longer lives, and longer working lives.

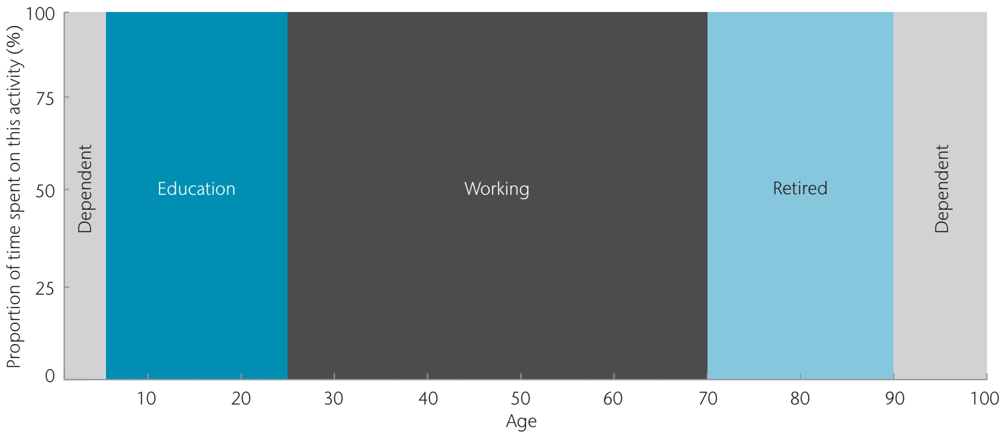
Male life expectancy at age 65 by country, 1960-2050



Source: Historical data on life expectancy OECD Health database 1960-95. Recent data and projections of life expectancy Future based on the United Nations Population Division database, World Population Prospects – The 2008 Revision

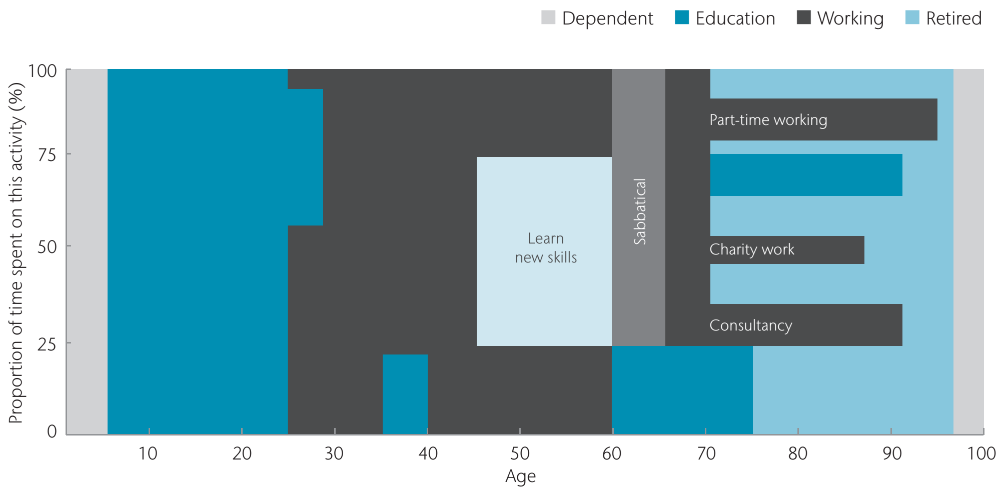
The increase in longevity and the changing shape of the workforce age profile mean that the nature of retirement needs to change. Retirement needs to change from a linear process – learn, work, retire – to a more flexible one, supported by suitable new products.

Traditional transitions



The cliff edge that is retirement should be replaced by a far more fluid series of transitions between work and (partial) retirement. Part-time work could become one of the regular transitions to full retirement. Retraining and re-skilling will be essential both to ensure relevant work experience and skills – and at a personal level for self-worth and personal development. Managing retirement finances will move from being a single decision at one point in life, to a series of decisions, some of which will be taken increasingly later in life.

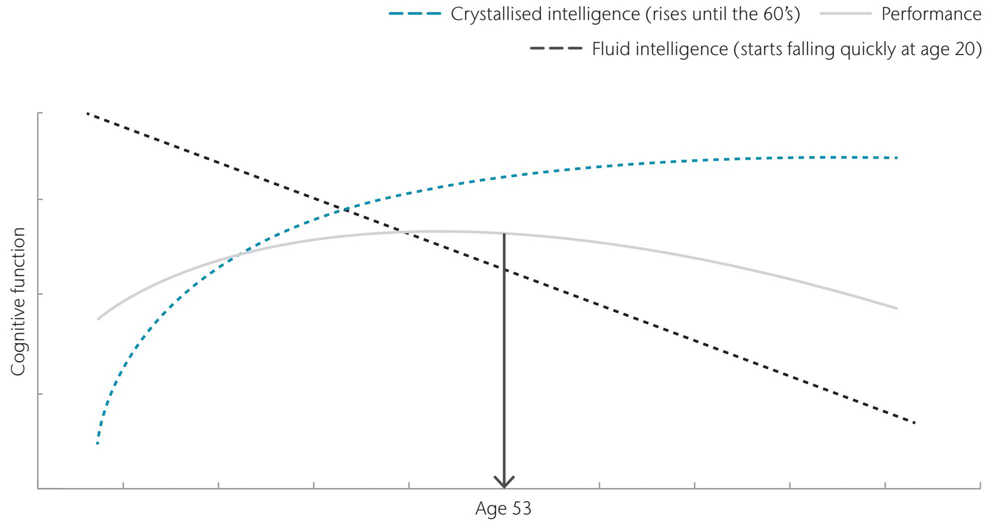
Future flexible transitions



In the UK we often speak of a U-shaped retirement – with high levels of activity and expenses in the early years after retirement (traveling the world, spending the children's inheritance etc) followed by a more sedentary phase in later retirement, and then an upturn in cost towards the end of life as nursing home costs kick in.

Our Australian colleagues (who as a nation are addressing the decumulation challenge[1] through what they call the development of Comprehensive Income Products for Retirement or CIPR) talk about three similar retirement phases – an active phase, a passive phase and then a fragile phase. We like this latter terminology because it highlights one of the challenges we face in designing suitable products and solutions. In later years, individuals may not have the same mental capacity (or willingness) to make complex financial decisions, as a result of so called cognitive impairment. Individuals will either need trusted advisers – or even trustees of our retirement products – that can take these decisions when they are not capable, or they must anticipate them in advance.

It is downhill even before you get to retirement...

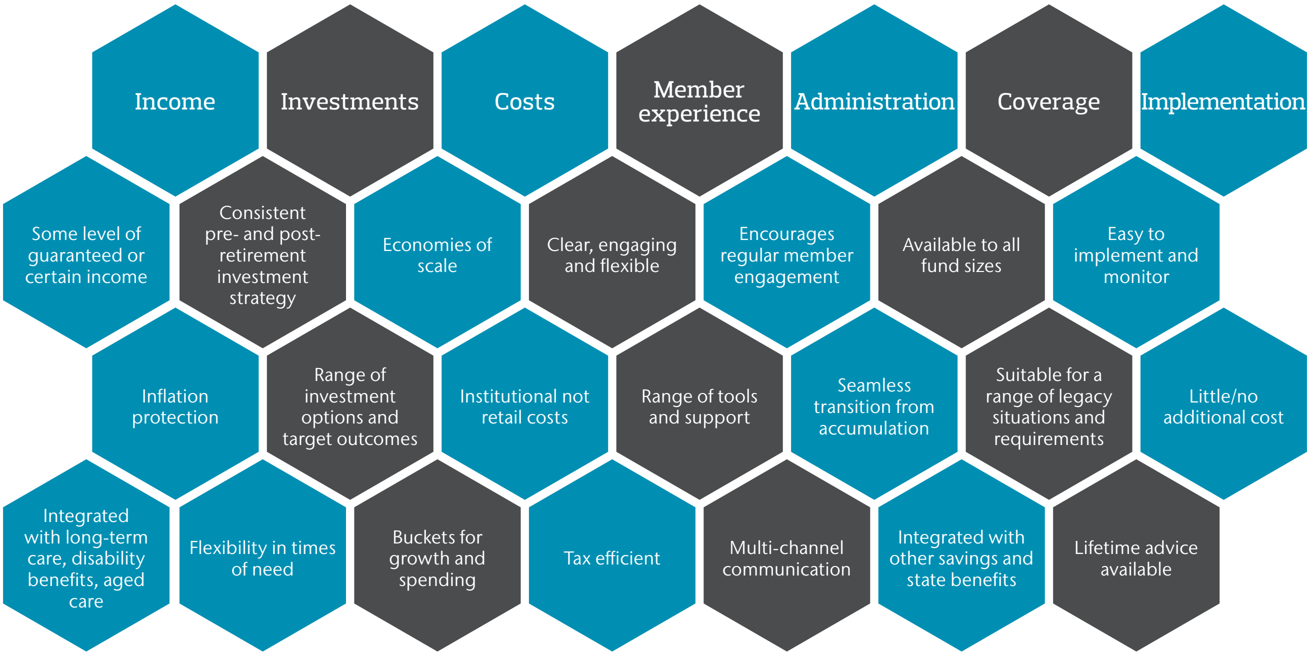


Source: Laibson, Harvard University "Behavioural Finance: Psychological barriers to Optimal Investing"

Retirement income products also need to reflect that while the three phase pattern might be expected, life has a habit of not working out as planned. So the transitions from active to passive, or from passive to fragile, may be sooner than expected as a result of ill-health — increasingly likely in a long retirement — or later than expected. There may be unanticipated demands for higher income — because of divorce, grandchildren's education or a host of other life events. Income requirements as a result of long-term care costs may be significantly higher than anticipated. Any solution we devise has to encompass flexibility to reflect changing circumstances.

When we pull all of these threads together, we can see that our demands for the optimum retirement income product are really quite challenging. The Aon Global DC community pulled together this shortlist of desirable, or even required, features for a major Australian superannuation fund considering the CIPR challenge.

What features would a retirement solution need to have?



Source: Aon DC Global Community

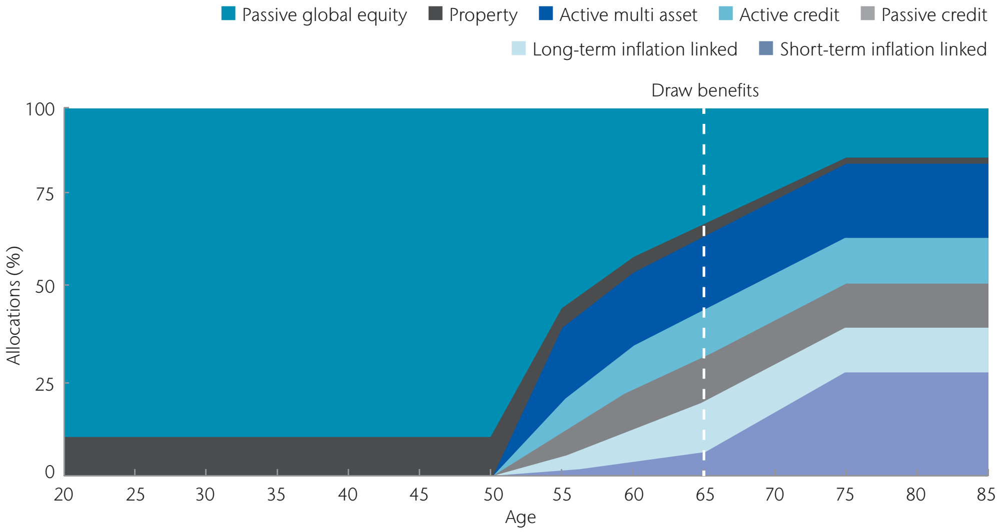
We can see there are many strands and issues to consider when arriving at our ideal future-proofed retirement solution. These include the type and level of income needed, the investment policy to back the design, engagement with the individual in the context of the totality of their finances, as well as the flexibility to deal with changes in their circumstances. This does look like a ridiculously long list of requirements – because it is!

So where are we on the journey to the ultimate retirement income solution – and what might we expect to see soon? Rather than tackling the whole list above, we will focus on five central components.

Investment policy

On the investment front we have made significant strides away from the bond-based solutions that underline annuity purchase. Decumulation investment solutions now feature a significant proportion of return seeking assets to reflect the need to generate investment returns to sustain a longer retirement. The best solutions would incorporate target date funds that move 'to and through' retirement – the underlying investment policy does not change at the point of retirement, there is de-risking though retirement until an advanced age, and ideally no physical change of assets on retirement – so no costs of asset switching or out of market exposure. The investment policy in retirement will increasingly become a multi-asset approach, to deliver returns with a higher degree of certainty, and less volatility.

Decumulation investment solutions



Source: Aon research

In today's environment, with low interest rates and low anticipated returns, guarantees are likely to look even more expensive – but may be increasingly valuable. When we are constructing portfolios that deliver best results for members who are drawing on their DC savings, we need to think about ways to increase the income generated (the so-called running yield) – by investment in higher yielding bonds and 'bond like' equities, albeit at the risk of higher defaults or downgrades.

And the investment solution needs to recognise the very real challenge posed by 'sequencing risk' – the order in which investment returns are achieved. A member in accumulation is indifferent if they get a return of 10% over two years by way of +20% in one year and -10% in the next year. However, if we are drawing down from the portfolio it does matter – if the bad year is first, and then we withdraw money, we cannot make it back in the following good year. Pound-cost averaging has become pound-cost ravaging. Less volatile investment outcomes are required.

Sustainable income

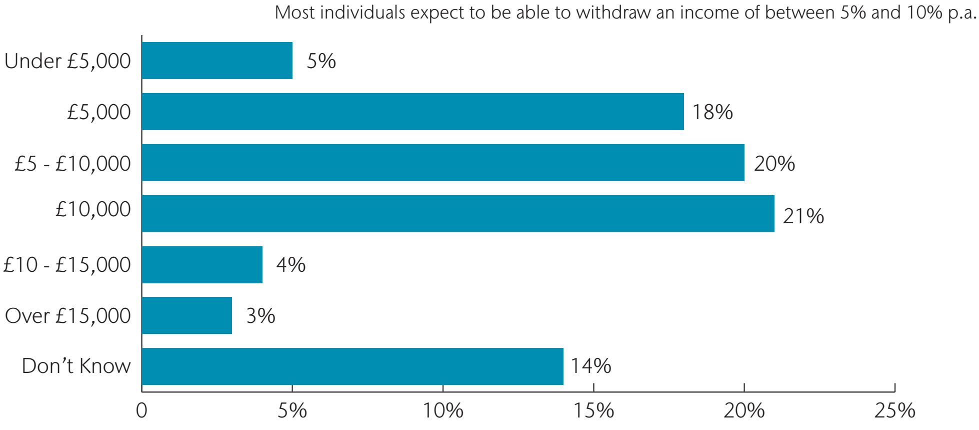
A key consideration is the sustainable level of income that can be drawn in retirement from the invested pension pot. Perhaps the most well-known 'rule of thumb' to answer this question is the 4% rule, developed by Bill Bengen, when working as a financial planner in Southern California in 1994. This said that taking an annual income of 4% of the DC pot – increasing in line with inflation – could be sustained with a 50/50 equity/bond portfolio through a 30 year retirement. Further analysis in 2015[2] concluded that the 4% rule was significantly more risky for today's retirees who face low bond yields, high stock market valuations, and increasing longevity expectations. Under this analysis the 'safe withdrawal rate' was considerably lower for new retirees in 2015.

Experience elsewhere backs up the need for caution – for example, in Australia, 25% of people aged 55 fully deplete their balances by the age of 70[3]. Closer to home, research by eValue for Aegon in 2017 suggested figures of 3.2% - 3.6% of pot size in current UK market conditions. But moving to a lower withdrawal rate exposes the individual to the converse problem – which is not about running out of money in retirement, but not spending enough of retirement savings. Leaving behind retirement savings on death may be a conscious decision as a bequest to the next generation, but it is clear that in many cases it is a consequence of not understanding how much the member could spend, until it is too late[4].

The Institute and Faculty of Actuaries recently released a policy briefing note[5] which promoted a figure of 3.5% for sustainable drawdown – meaning there was a low chance of exhausting one's retirement savings before the age of 100. However, this comes with important observations that this 3.5% drawdown level is a level figure, rather than inflation linked, so is not comparable with the 4% rule earlier. And the paper seems to contradict itself by illustrating the inherent problem – if you take a rate that is low enough to ensure there is money left at an advanced age, then there will be a lot left over at the expected date of death – about one half of the savings under this research. We need more explicit methods to deal with longevity, an issue we return to below.

Perhaps individuals should be trusted to get this decision right? We fear not. Research carried out by Ignition House in 2014 for NEST asked individuals how much income each year they would expect to take from a pot of £100,000? The results illustrated show either a very optimistic view of the returns to be achieved or perhaps a very pessimistic view of their own future longevity. NEST's own suggestion for future income provision[6] took the decision about a sustainable rate of withdrawal away from individuals, and gave it to trustees acting on their behalf, and in their best interests.

How much income each year would you expect to take from a pot of £100,000?



Source: Igntion House for NEST

Another approach to the question of sustainable income is to focus on so called ‘income funds’ – investments that pay out the underlying dividends and interest from the portfolio, while leaving capital intact. These are a simplistic means of addressing (or avoiding) the sustainability question – the portfolio is inherently sustainable, as long as the level of income does not place the capital at risk. There is an inherent tension here: investments with a higher running yield – such as low grade corporate bonds, for example – will in general be associated with higher risk of default. Moving to equity-based investments opens up much greater capital variability. There is no free lunch.

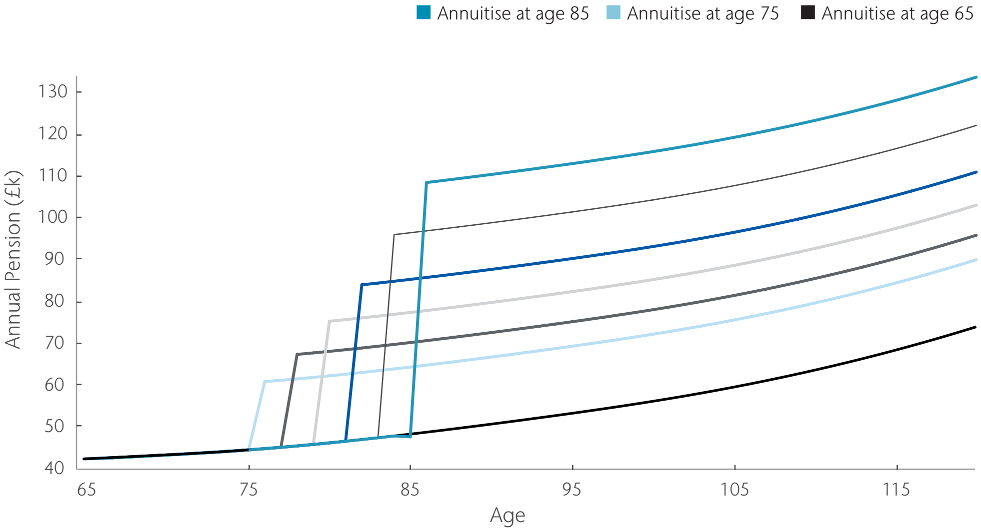
More importantly, it is not the case that all DC savers will have the luxury of being able to leave their capital untouched. Where DC savings form the bulk of a saver’s income (on top of state benefits) we need ways to convert all of the savings – income and capital – into pension income. We have to tackle longevity.

Longevity risk management

The issue of longevity – making sure you do not outlive your savings, or equivalently that you do not exhaust them before the end of life – is a challenge that is really only starting to receive attention. The Financial Conduct Authority[7] bemoaned a lack of innovation in the UK market, although they did accept that we are in a transition at present where legacy defined benefit (DB) pensions form a major part of many retirement incomes, and DC pots are effectively an additional bonus on top. As we move to a position where DC income is increasingly dominant, we need those more durable longevity solutions.

Annuities may well still have a role to play. They could provide certainty of a basic income – either throughout retirement, or in the passive or fragile phases mentioned above. In other words, they could be immediate or deferred annuities. The immediate annuity might make payments into the drawdown pot, rather than paying out as cash, enabling a hybrid annuity/drawdown solution with a higher investment return/risk approach to be adopted. One important question to decide – over and above what type of annuity (single, joint life, fixed, escalating etc) – is when to buy a lifetime annuity. Research by an Aon colleague as part of a degree dissertation[8] suggested that, allowing for risk, the optimal age to annuitise is in the late 70s. Many individuals might consider this would be too late, and may be fearful of putting off this big decision – so perhaps more regular purchase of annuities (deferred annuities) is the solution?

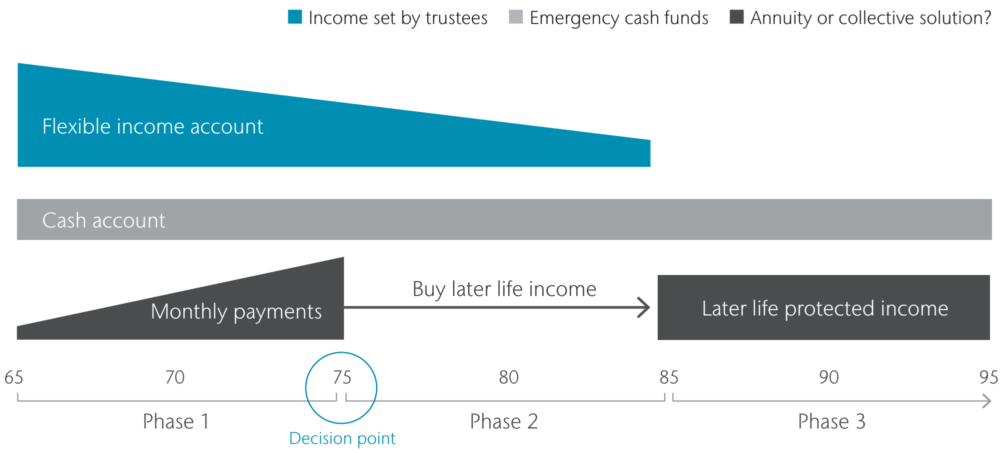
The answer is an annuity – but when?



Source: An analysis of potential retirement outcomes for ordinary retirees post Pensions Freedom Day : Rebecca Peake, Aon

Deferred annuities sound attractive but they are expensive, because of the very uncertainty of the longevity they offer protection against. While the basic premium for a deferred annuity payable from, say, age 80 may not be too expensive, the reserves that need to be held by a Solvency II regulated insurer are significant. Those reserves need to factor in one in 200 year shock events – and a shock event here could mean a cure for cancer or other breakthrough that would make an annuity extremely costly. One partial defence would be to make regular purchases of deferred annuities during the active and/or passive phases – an approach developed in the NEST consultation on decumulation and illustrated overleaf[6].

The NEST blueprint



Source: NEST the future of retirement

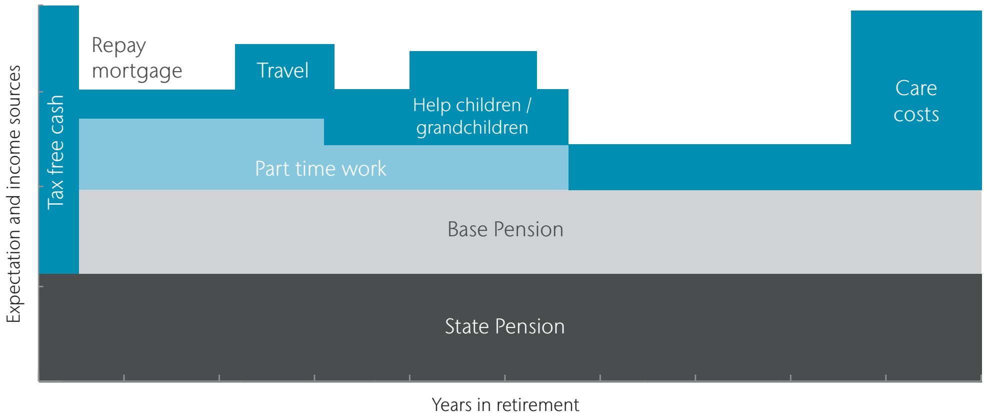
An approach which is being increasingly discussed elsewhere – notably in Australia and the Netherlands, usually considered among the best retirement system in the world – is the idea of collective DC solutions (CDC), under which longevity risk is pooled and shared among participants, rather than being insured via an external insurance company. Risk sharing in this fashion offers the prospect of materially cheaper longevity protection, because it obviates the need to hold reserves against extreme events. The legislation to offer CDC-style risk sharing income is already in place in the UK[8], although it is fair to say that the Department for Work and Pensions (DWP) would need to pass some significant quantities of regulations to bring them into existence – especially if the CDC-style annuities were offered on a commercial basis through competing master trusts. However, once this legislation becomes operational, we might even see the largest employers being prepared to offer CDC income solutions from inside their schemes. Until then, it is down to providers to offer these solutions through master trusts and the like.

Purchasing deferred annuities to provide a secure income from, say, age 80, sounds a really attractive hypothetical solution to dealing with the risk of longevity. It deals with the issue of cognitive decline. It turns the spending issue for drawdown into a finite number of years, rather than an unknown, indefinite lifespan. The thought of 'wasting' money on an annuity that you don't live to draw, can be addressed by adding in a return of premium option on death before 80 – albeit at extra cost. We know that these combination drawdown and repeated annuity purchase solutions are being pioneered in the US, and that this type of product was developed and launched to the UK retail independent financial adviser (IFA) market between 2007 - 2009. However, the products did not get any traction among the UK's IFA community – who might have been expected to see them as a useful part of lifetime pension planning[10]. Is it time to make them a reality again in the UK?

Flexibility

What do we really mean – and what do members mean – when we talk about the need for flexibility in designing retirement savings? Flexibility could refer to spending patterns in retirement, such as those illustrated – variable levels of income that change according to changes in circumstances.

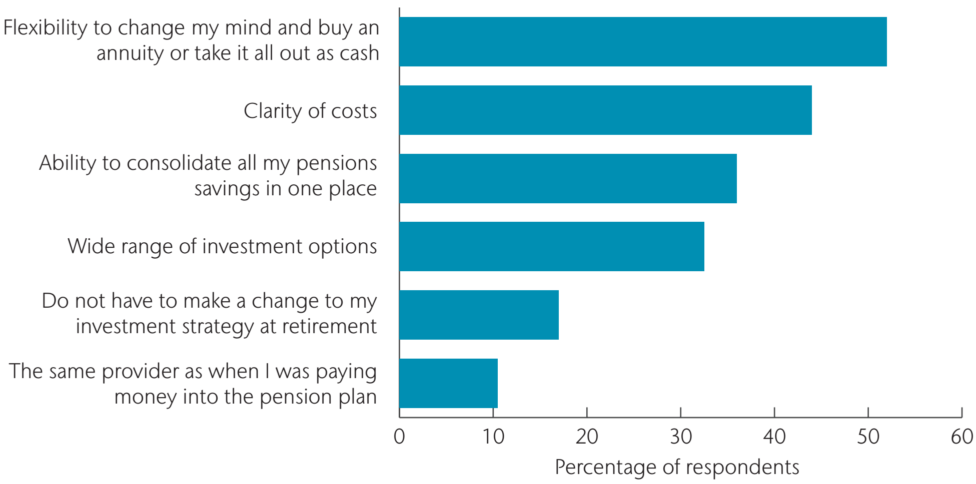
Is this what we mean by flexibility?



Source: Aon research

There is no doubt that our products and solutions need to cope with this variability. But often we confuse what members mean by flexibility.

What are you looking for in a product that leaves your pension fund invested after you have retired?



Source: Aon 2016 DC Member Survey

As part of the 2016 Aon DC Member Survey, we asked around 2,000 DC members what they were looking for in a retirement product. They told us that what they were really looking to avoid was making a 'wrong' decision. Flexibility meant not having to make an irreversible decision. Analysis elsewhere suggests this is one of the reasons why people dislike annuities – once they have made the decision, there is no going back. People would rather not make a decision than make what might be a wrong decision. So flexibility means having another chance to take that decision. Or rather than one big decision, perhaps a series of smaller decisions?

A sideways thought. We are so used to thinking of retirement income solutions – paying out cash – but should we be focusing on providing services (or access to services) as well? Could we meet the needs of retirees more directly than giving them cash? This might feel somewhat utopian, but we have in mind that some of the key needs, such as aged care, or healthcare requirements, could be provided under a combination approach with insured elements forming part of the comprehensive package. Indeed, thinking about a basic need for accommodation, helping individuals in the accumulation phase to buy their own home, where they can live in retirement and save on housing costs, would seem to be consistent with this concept of providing services. So, perhaps a product that combined house purchase and retirement savings? Hmm – corporate LISAs anyone?

Decision support

One of the most important member needs in retirement is help and support to continue to take the financial decisions about their savings. Solutions that are to be robust must address this central need. Members will need help deciding where to invest and how much to draw out from their retirement savings. Ideally they would have support to decide whether to access pension savings or other forms of savings, such as ISAs, to optimise personal tax planning. Members will need support with deciding how and when to address their longevity needs - when should they annuitise for example? And importantly, when should they hand over decisions to somebody else? What members ideally want is their own personal trustee, empowered to take decisions on their behalf, acting in their best interests. An IFA might provide this service – for a segment of the market (high net worth) but this is not a practical solution for the mass market.

Many employers would be concerned that this is dangerous territory – just leave members to do it for themselves. But is this really the way forward? Employers have worked hard throughout the members' working career to design a competitive, attractive plan with low cost and good investment options. Then at the time members are facing perhaps the biggest decision of all, they are left on their own? So is the choice of retirement option and provider firmly in the camp of the individual, rather than the responsibility of the employer or trustee to put a solution in place? After all, there is a lot of choice isn't there?

The regulators have not yet codified and published what they think "good" looks like, so employer and trustees have no external standard against which they can benchmark, and get themselves comfortable if they are signposting to a preferred provider. So let members do it for themselves? We have posted below a selection of names that members might come up against if they were searching for pension drawdown solutions.

Name
Pension Services
Pension 2 Cash (also trading as Early Pension)
The Pension House (clone)
The London SIPP Company / The London Pension Company Ltd
CashInMyPension.com /James Cockle /Capital Solutions
Pension Release Scheme
Pensions-UK 123 Ltd
The Pension Help Desk Limited
Release My Pension
Wefindanypension.com Ltd

Source: https://www.fca.org.uk/consumers/unauthorised-firms-individuals#glossary

Do any of these names look familiar – or trustworthy? Or useful to an average pension scheme member looking to decide how to spend their hard earned retirement savings? Hopefully you have not made transfers to any of these organisations – they are all listed on the FCA Warning List of unauthorised firms, and members would be warned of scams. Do you really think you should leave your members to face pension decisions alone?

Decision making will often come down to a question of trust – who do individuals trust to take these important, and very tricky, financial decisions on their behalf: their partner, their employer, the product provider, their solicitor – or perhaps a robot? Algorithmic or artificial intelligence solutions are starting to appear – not just modellers to help decide attitudes to risk and drawdown levels, but also annuitisation prompts and consideration of total wealth. But algorithmic solutions have their own issues.

Just what advice does your robot cover? As well as the drawdown rate, and investment policy, it really needs to consider your attitude to risk, and capacity for loss. It needs to know whether you have emergency funds or any debts and liabilities. To give even half-decent advice the algorithmic advice need to be holistic. This in turn means lots of form filling for members before they can access the advice. And experience suggests that members are not prepared to spend many hours talking to a computer screen before they get any answers back. We are only now seeing the start of more comprehensive financial support systems that can deal with all of these questions for the individual and in an unobtrusive fashion that can be delivered cost-effectively. We need regulators to accept that these will not be perfect solutions – but the best is the enemy of the good here, and unless we have relatively simple systems that cope well with the majority of cases (accepting that at the margins, some cases will not get 'best' advice) then not only will members refuse to engage, but the systems will not reach the mass market they need to.

Bringing it all together

Decumulation is a challenge – but one that we need to face up to as an industry and deliver solutions that meet real needs. And we need to be working with the grain of what those needs will be as pensions, work and life change – dealing with the consequences of the 100 year life[11]. This means a long overlap or transition phase between work and retirement – so our products need to accommodate both accumulation and decumulation, with industrial quality and pricing for both, rather than a high-quality, low-cost savings vehicle bolted together with retail priced decumulation solution.

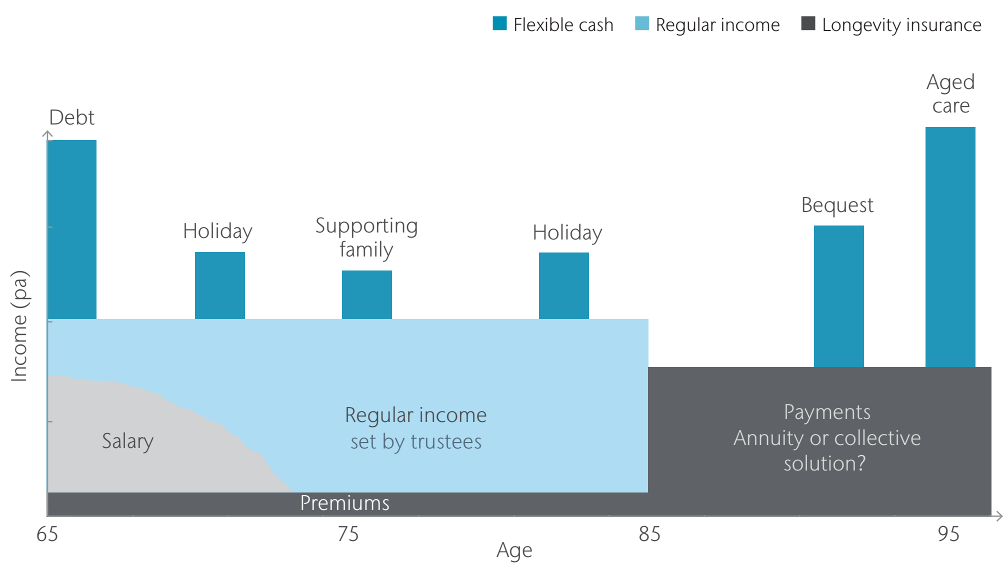
Our research indicates there are three central components of a high-quality decumulation solution in the freedom and choice era – stability, flexibility and durability.

Stability – individuals need a basic level of fairly predictable income to last them throughout their life in retirement. This need not be a wholly guaranteed level of income – most individuals will have a degree of resilience to some small variation in this income, since they will have other sources, such as their state pensions. This base income would ideally be linked to inflation, measured by some of the basics of the cost of living for pensioners. It could be as simple as going back to the rules that existed before pension freedoms, where you had to prove you had a set level of guaranteed income to cover basic living costs before you could use drawdown.

Flexibility – as we have seen, personal circumstances will vary over the course of retirement. The solution needs some flexibility to cope with these changes – both the positive changes (extra spending on grandchildren) and negatives (health costs, divorce etc). The solution also needs flexibility built in as far as entry is concerned – there may be multiple repeated partial entries into what we currently call retirement.

Durability – retirement savings need to last a lifetime. Not significantly longer, but also not significantly shorter. Some form of longevity protection needs to be built into the solution. This does not rule out under-consumption or over-consumption to suit personal circumstances, but our central solution should be designed to convert a savings pot into a lifetime of retirement income. This will almost certainly involve some form of annuity solution – immediate or deferred, insured or collective – or explicit longevity insurance: we note that many of these solutions do not yet exist!

Potential Australian CIPR design concept



Source: Aon research

Our own research – in the UK and around the world – is leading us towards solutions building in these three components, underpinned by intelligent decision support (or better still no decisions required by members) and first class administration. Our schematic for this, illustrated above, forms part of our submission for the Australian CIPR[1] debate, with a base level of regular income, longevity protection (via regular purchase of deferred collective annuities), and sufficient funds left over to generate some flexible spending to cope with long lives. Decumulation is the next crucial key phase in the maturation of DC schemes. It is time for the industry – and for employers and trustees – to face up to the reality of spending in the same way they have faced (with some considerable success) the reality of saving.

Contact us

Contact our dedicated DC experts to discuss the ways we can add value to your DC pension scheme and its members.

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9 *Pension Schemes Act 2015 – Part 3 Collective Benefits*
10 *State Street and the Regents of the University of California, "Addressing Longevity Risk in Defined Contribution Plans with a Lifetime Income Solution".*
11 *The 100-Year Life – Living and Working in an Age of Longevity, by Lynda Gratton and Andrew Scott.*

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