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LIFE SUPPORT: HELPING DC RETIREES TO BE WISE

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Decision-making patterns among defined contribution (DC) retirees suggest they need more support to make good retirement choices.

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- When asked how difficult it is to make decisions about their money at and in retirement, over half (52 per cent) of DC retirees said it was more difficult than naming a child, according to survey findings from Columbia Threadneedle Investments.
- People are making radically different choices with their pension pots at and in retirement now that they no longer have to buy an annuity.
- The potentially severe consequences of inertia or making a wrong decision will compound over time, as future retirees become ever-more reliant on their DC savings.
- DC retirees need more support, perhaps in the form of an automatically enrolled default through-retirement solution which would provide both a secure income for life and a degree of flexibility.

Those approaching retirement are more at risk of spending their retirement in poverty than at any time in a generation. The government's freedom and choice policy has opened the investment floodgates, allowing anyone aged 55-plus to make their own decisions with their retirement savings, but it has not come with a safety valve attached.

The potentially severe consequences of sub-optimal decision-making, indecision and inertia are becoming increasingly clear as post-freedom and choice decision-making patterns start to emerge. The situation will only grow more acute as defined benefit (DB) pensions decline and people start to increasingly rely on their DC pension pots.

People could be helped if the principle of auto enrolment, currently applied to the retirement saving phase, were extended further. Automatically enrolling DC retirees into a well-regulated default through-retirement solution, which would provide a secure income for life allied to a degree of flexibility, could solve many problems. It would help them to avoid spending their money too quickly or leaving it in cash, rendering it devoid of growth prospects and susceptible to the potential ravages of inflation. Automating the retirement process would be a natural follow-on from auto enrolment at the start of individuals' retirement saving lives. It would spare people from retirement decision-making, which after a lifetime of inertia, they, understandably, find immensely difficult.

As people live for longer, their DC pots may have to sustain them for 30 years or more. Yet it is apparent that the mid- to late-baby boom generation are not accumulating enough to sustain them through their twilight years, according to new research by Columbia Threadneedle Investments and YouGov.[1]

Considerably more than half (60 per cent) of the survey's 55-to-64-year old respondents had either retired or planned to retire between the ages of 60 and 69, while over three quarters (77 per cent) expected their retirement to last for more than 20 years. However, only 69 per cent believed their pension pot would last them for the full term of their retirement. This might explain why over half (52 per cent) of respondents are expecting to work until or beyond state pension age.

Many of the baby boomers surveyed had made no concrete plans about their retirement finances. Disconcertingly, 28 per cent didn't know how long their pension savings would last, while over a quarter (26 per cent) didn't hazard a guess as to the likely duration of their retirement, despite only seven per cent being uncomfortable thinking about their own mortality.

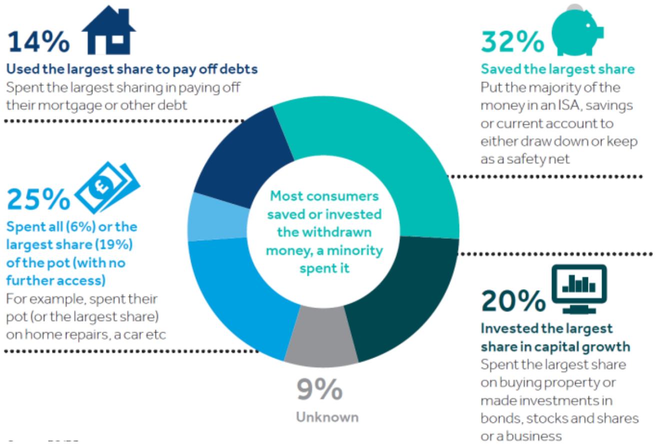
The same demographic is also underestimating how much income will be needed to live comfortably in retirement. Nearly three quarters (74 per cent) believed an annual income below £25K would provide a "comfortable" retirement. By contrast, the Pensions and Lifetime Savings Association (PLSA) recently suggested that securing a comfortable retirement would require a minimum income of £25K per annum.[2]

Retirees are not always making sustainable choices with their DC pension pots. Research from elsewhere in the pensions industry suggests that many DC pots are being used for discretionary spending, or simply being left to languish in cash deposits.

[1] Planning for retirement. Are people joining up the dots? Columbia Threadneedle Investments and YouGov. February 2018.

[2] In a recent survey of 55 to 64-year-olds, the PLSA suggested that securing a comfortable retirement would require a minimum income of £25K per annum. See: Hitting the Target – Delivering Better Retirement Outcomes. PLSA. October 2017.

Figure 1: What have people done with their fully encashed pension pots?



Source: Retirement Outcomes Review Interim Report. FCA. July 2017.

The Financial Conduct Authority (FCA) estimates that just over half (53 per cent) of pots have been taken fully in cash. Of these pots, 25 per cent has been spent on home improvements and discretionary items and over 50 per cent has been invested in other savings and investments, including 32 per cent in low-yielding cash deposits, according to the FCA (and illustrated in Figure 1). The latter was partially motivated by a mistrust of pensions and of government pensions policy. In some cases, this would have resulted in a considerable income tax charge and in many cases compromised tax-inefficient investment returns.

Meanwhile, many DC retirees in purchasing annuities or investing via income drawdown are not shopping around for the best deal with their pension savings. Nearly 60 per cent of consumers purchase annuity and income drawdown contracts from their existing pensions provider without scouring the market, while a dwindling proportion of these purchases are made on the back of regulated advice, according to the FCA.[3]

Stark realities

The consequences of leaving people unsupported when they make decisions with their retirement savings are starkly illustrated in Columbia Threadneedle Investment's research, which largely focused on those aged 55 to 64. Many of those approaching retirement struggled to make a decision. When asked how difficult making choices about how best to use their pension pots in retirement was, over half (52%) said it was more difficult than naming a child. Moreover, of those who had made a decision, 37 per cent had yet to implement it.

Of those with a DC pension pot and/or a Self-Invested Personal Pension (SIPP), over a third (35 per cent) have yet to decide on how to convert their pension pot into income.

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[3] Data Bulletin. Issue 8. Financial Conduct Authority. February 2017. p.16.

When asked why they had not made a decision, 30 per cent said that retirement was a long way off. Almost a quarter (23 per cent) didn't know what the available options were. Meanwhile, 17 per cent didn't trust the pensions and/or investment industry with their money, while 14 per cent weren't prepared to pay for financial advice. These latter two issues were a bigger concern for the survey's respondents aged 65-plus. Of those who had decided to opt for income drawdown, nearly two-thirds (63 per cent) did so because of the flexibility it offered.

A study by The People's Pension echoes these findings. The researchers followed 80 DC investors, who were considering accessing their DC pension pots over the eight months from June 2015 to February 2016, to see what decisions they made over the subsequent 12 months.

The risk averse took two main routes. Some opted for annuitisation, treating this avenue as passing on the investment risk to "the experts". Others withdrew their money and put it into a cash account in the belief they were "taking control" and their money was now "safe".

Indecision and procrastination meant that many retirees failed to do anything with their pension pot. Many people who were making decisions with their DC pension pots were influenced by recent family events or health issues rather than formulating a long-term financial plan. For the sandwich generation, those with elderly parents and often still financially-dependent adult children, family events and health issues can have a strong short-term impact on decision-making.

Wording retirement options

People's retirement decisions are very likely to be influenced by the language framing the different options, the FCA found in a separate study.[4] When consumers were told the likely income they would receive for spending in retirement, 66 per cent of consumers surveyed preferred the characteristics of annuities over income drawdown.

However, when an 'investment frame' was used, set solely in the context of the size of the pension pot invested and the returns accruing on that investment, to the exclusion of income generation and consumption considerations, only 17 per cent opted for an annuity. Indeed, the latter frame when applied to an annuity caused many investors to conjure up thoughts of their pension pot being used as a one-off longevity gamble, with their money remaining with the annuity provider, the insurance company, and not forming part of their estate on death.

Interestingly, when the term 'annuity', rather than a simple description of what an annuity provides, was used, the preference for annuities declined from 66 per cent to 50 per cent. So, while the characteristics of an annuity appear to be valued, the term itself has perhaps become associated with poor value.

[4] *Does the framing of retirement income options matter? A behavioural experiment.* Financial Conduct Authority. December 2014.

Making better choices

The stakes are high for DC retirees – and they are set to get even higher. The potentially dire consequences of inertia or making a wrong decision will compound over time.

DB pensions are disappearing. In future, people will become solely reliant on DC pension pots to support their desired standard of living in retirement which, for many, will extend to 30-plus years. Also, as life expectancy increases, people are receiving their state pension ever later in life.

If not managed well, the risks of sub-optimal decision-making, decision paralysis and inertia, combined with a continued lack of guidance and accessible advice and the absence of behaviourally robust and well-governed default solutions, will culminate in an uncomfortable retirement at best. Worst case, it will lead to the retiree outliving their savings.

Whatever they do, people are making decisions without the full set of facts. The fundamental uncertainty is life expectancy. In addition, for many people, retirement is no longer a one-off event with a well-defined destination point. Rather, people are increasingly adopting a phased approach to retirement, with some choosing to continue to work well past state pension age, as many of the Columbia Threadneedle Investments survey respondents intended.

However, people must often contend with unforeseen changed circumstances, whether family or financial, along the way. Another complicating factor is the considerable cognitive impediments to informed decision-making, which typically compound with age.

All of this adds up to, according to the FCA's assessment, the most difficult of life's financial decisions.[5] Indeed, most people are ill-equipped, let alone sufficiently engaged, to determine the retirement choices that will be best for them. At the very least, people need more support to make these choices, in the shape of better guidance and more accessible advice if they are not to sleepwalk into retirement penury.

Being automatically enrolled into a default through-retirement solution which would provide both a secure income for life and offer some leeway to dial withdrawals up and down, may also help to simplify the process, said over half (53 per cent) of Columbia Threadneedle Investments' group of baby boomers. After all, most DC savers seek a combination of flexibility and income security.

In the next papers in this series, we will debunk some myths about the pattern of spending throughout retirement, consider the importance to income drawdown investors of determining a sustainable income withdrawal rate and explore the importance of investment strategy in underpinning a more comfortable retirement. Finally, in a continuation of our theme around automatically enrolling DC retirees into a

[5] Financial Advice Market Review. Final Report. Financial Conduct Authority and H M Treasury. March 2016. p25. According to Nobel prize winning economist Bill Sharpe, this decision is "the nastiest, hardest problem in finance."

well-regulated default through-retirement solution, we then examine what a fit-for-purpose solution might look like if retirement is to be enjoyed and not endured.