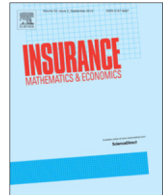
ARTICLE IN PRESS

Insurance: Mathematics and Economics ( ) –

Contents lists available at ScienceDirect

Insurance: Mathematics and Economics

journal homepage: www.elsevier.com/locate/ime



The effect of longevity drift and investment volatility on income sufficiency in retirement[☆]

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ARTICLE INFO

Article history:
Available online xxxx

Keywords:
Pensions
Longevity drift
Annuitisation
Drawdown
Investment volatility

ABSTRACT

In 2014 the Government announced radical proposals which now allow people to withdraw money from their pension pot from age 55, 'how they want, subject to their marginal rate of income tax in that year'. The main effect of this change will be to put more onus on the individual to make sure they have sufficient resources to last for their retirement, but it also removes the obligation to annuitise their funds at any future age. This paper is concerned with how people can best use their pension pots by aligning them to their personal financial objectives and longevity risks. It finds that for most people annuitising is *not* the best option, except for a few circumstances, and that draw down is preferable, especially where there is a bequest motive and the individual has assets such as property to fall back on. These options are low risk if simple rules are followed but they are not a substitute for professional advice and should only be used in conjunction.

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1. Introduction

Historically, a majority of people in the UK (around 75%) with a defined contribution pension plan bought an annuity at retirement with their pension pot.[1] The main advantage of an annuity is that it provides a guaranteed income, in either nominal or real terms, for life; hence the individual no longer bears any investment or longevity risk.

In 2014, the Government announced radical proposals which now allow people to withdraw money from their pension pot from age 55 (rising to 57 in 2028), 'how they want, subject to their marginal rate of income tax in that year' (see HM Treasury, 'Freedom and choice in pensions'[2]).

By removing the obligation to annuitise pension funds upon retirement or any future age, there is now more onus on the individual to make sure they have sufficient resources to last for their retirement and, if they choose to spend their money otherwise, to ensure they are aware of the possible consequences.

It is widely accepted that these and other changes, including tax adjustments, will have an enormous impact on the pensions industry as a whole and also wider ramifications in terms of tax and estate planning (PWC, 2015).The full effects will take time to mature, but companies providing wealth management services will clearly be one of the main beneficiaries.

Opening up such choices to people can be risky unless they are adept in financial planning. The evidence is that whilst some are, most are not (Money Advice Service, 2013) and having a financial health check before committing to an annuity will become more important.

As has been widely noted, managing the transition into retirement can be complex (Pensions Policy Institute, 2014). Pensionwise is a free and impartial government service about your defined contribution pension options which provides users with helpful information and so fills some of the information gap (www.pensionwise.gov.uk/).

Our aim is to go beyond what is on this website in three ways: Firstly, to personalise what to do with pension pots; secondly, to be able to assess the value of annuitising versus the alternatives; and thirdly, to look at other sources of retirement income if the pot runs out.

For an individual, there will be three key things for them to consider when deciding on a strategy to manage their pension pots:

1. The risk of living longer than expected and running out of cash, and hence whether to manage this risk by buying an annuity at some point during retirement.

☆ Paper presented at Longevity 11: The Eleventh International Longevity Risk and Capital Markets Solutions Conference, 7–9 September 2015, Université Lyon 1, Lyon, France.

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1 Pensions: income drawdown: Standard Note: SN 712, House of Commons Library.

2 HM Treasury (2014) Budget 2014: Policy Costings https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/295067/PU1638_policy_costings_bud_2014_with_correction_slip.pdf.

https://doi.org/10.1016/j.insmatheco.2017.09.013
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2. Any gift or bequest motive or plans for a major purchase that may affect the rate of drawdown or investment strategy.
3. The volatility of investment returns in the absence of annuitisation including potential tax liabilities.

How individuals will act as a result of this new freedom is, at the moment, largely guesswork. The Treasury, for example, estimates that around 30% of people who have assets in defined contribution schemes will decide to drawdown their pension at a faster rate than the income received via an annuity (HM Treasury 2014, see footnote 1 above).

The industry view, and also our own, is that the flight from annuities will be larger than this, as many embrace the new freedoms. Actual behaviour will depend on a range of factors including the size of the pension pot and the availability of other retirement income, and also any other financial assets such as housing wealth.

Any reduction in entitlement to means tested state benefits must be considered, especially for those with small pension pots (the median pension pot size is less than £20k currently) and only the state pension for income. In these circumstances spending the pot may be the better option as compared to generating an income; if so advice should be sought first on which benefits may be affected before taking action (e.g. help with paying local Council Tax).

There are strong indications that this was a key government concern at the time. In October 2015 it announced that a person reaching state pension age before 6th April 2016 would be eligible to increase their state pension by up to £25 a week on payment of a lump sum estimated to be about £22,250. On the open market we estimate that this sum would only buy a fully indexed annuity worth initially about £18.60 a week and hence this is a clear inducement to try and head off this behaviour as well as meeting other goals.

The state pension is also transitioning into a higher flat rate pension from 2016 and because its value is guaranteed and underwritten by the state, it can be relied upon in hard times. Together these considerations can tip the risk profile away from annuities in favour of drawdown at the margins, though the arguments are finely balanced and depend, as we shall argue, on wider personal circumstances.

Although the issues are potentially complex, opportunities for retirees are enormous, but the risks are different (Brancati and Franklin, 2014). The previously automatic requirement to annuitise is replaced by other concerns such as longevity risk, inflation and investment returns. Many will find this challenging and so we believe people should seek a financial 'heath check' before deciding on what to do with their pension pot (Mayhew and O'Leary, 2014d; Pensions Policy Institute, 2014).

Our paper seeks to inform such decisions by linking options to individuals based on their health, other sources of wealth (especially property) and any bequest motive (which can include a cohabiting partner as well as friends and relatives). In doing so, we focus on using a person's pension pot to maximise their lifetime income whilst balancing risk.

Although a pension pot can be accessed from age 55, our basic starting point is a person aged 65 in order to align our analysis with the approximate commencement of the state pension.[3] We consider a person with accumulated pension pots worth £100k. This individual is used for illustrative purposes only and represents someone whose options are especially finely balanced.

For example, a much larger pot than £100k can be drawn down with little risk of being exhausted whereas, as we shall argue, a smaller pot is usually better off being spent. In fact, many people in this situation will be in a position where their pension pot will not be able to provide them a suitable retirement income.[4] Therefore it is people in this middle ground who need to weigh the options most carefully.

The logic of our analysis suggests that people will start viewing their pension pot, home and other assets collectively as their source of retirement funds. However, we do not discuss the significant risk of incurring costly long-term care in later life as most people's pension income or their size of pension pot would not be able to cover this. This requires separate analysis and is only touched on briefly.

The paper is set out as follows:

- In Section 2, we review what the effects of the new flexibilities are likely to be on the decision to buy an annuity by aligning a person's decision to their retirement strategies.
- In Section 3, we deal with two types of longevity risk, which we call the selection effect and longevity drift, and the difference that these will make to future financial planning.
- In Section 4, we provide worked examples of different drawdown strategies and address the question of whether the risk that a retiree will run out of money can be avoided without buying an annuity?[5]
- In Section 5, we consider the timing and bequeathing of wealth.
- In Section 6, we consider the integration of housing wealth into retirement planning and ask the question 'what if the pot does run dry?'

Our general conclusions are then set out in Section 7.

2. Pension options

2.1. Risks applying

With the exception of annuities, in which one is locked in until death, it is possible to switch strategies over time (although the government is also looking at ways for individuals to cash-in their existing annuities).

An important consideration is the 25% tax-free part of the pension pot. Under previous regulations, people were expected to take this amount in full at retirement. In this sense, the options of how a pension fund would be drawn down were entirely predetermined, but now all that is changing.

Nevertheless, we expect this behaviour to continue in most cases, as many people will have based their retirement plans on accessing the whole pot on retirement, notwithstanding the possible tax implications. Some, however, will leave the untaxed component untouched to generate a greater tax-efficient investment return.

Table 1 sets out the main options available to people. These are not designed to be mutually exclusive since a typical individual may split their pension pot in more than one way by adopting a hybrid strategy e.g. annuitising some of the pot and spending the rest flexibly or delaying annuitising until a later age.

The basic options are to: (A) withdraw all of the pot at the outset; (B) draw down money each year until it is exhausted; and (C) anuitise. Each has various pros and cons as listed in Table 1.

No single option provides any income guarantees except for (C), annuitisation i.e. the status quo. This has the sole but important

[3] State pension age for men and women is changing and being harmonised so 65 is used here as a guide.

[4] Pension pot sizes vary widely. For persons age 55 +and earning between £35k and £50k a year, the average value of pension pots is above £35k but the median value is much lower at less than £20k. Source ONS 2010/12 and ABI.

[5] An obvious advantage of this is that when you die, a carefully calibrated flexible draw-down strategy will always have some money left over, whereas an annuity dies with you.

Please cite this article in press as: Mayhew L., et al., The effect of longevity drift and investment volatility on income sufficiency in retirement. Insurance: Mathematics and Economics (2017), https://doi.org/10.1016/j.insmatheco.2017.09.013.

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