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## U.K. Freedom and Choice in Pensions: A Free Lunch or Retirement Roulette?

For the U.K. life insurance industry, the impact of the Chancellor of the Exchequer's budget statement, "Freedom and Choice in Pensions"<sup>1</sup> has been immediate and real.

Before 19 March 2014, the amount of income that could be drawn from a pension was limited to the level of a fixed payment lifetime annuity. This restriction, combined with tax charges on death, and rules governing communications between providers and policyholders, meant that buying a lifetime annuity was the default retirement option.

The increase in the Government Actuary's Department (GAD) limit and the planned removal of punitive tax charges on withdrawals substantially undermines the rationale for the lifetime annuity. For accumulated retirement savings, liquidity is now an option.

BlackRock®, a leading player in U.S. retirement savings, regards up to \$25bn of U.K. pension savings annually as "money in motion."<sup>2</sup> It has "no doubt that the budget has created an opportunity for it to challenge the incumbent U.K. pension providers."

While these developments are interesting for BlackRock and the embattled U.K. life industry, they are even more interesting for pensioners and retirement advice professionals, who are the focus of this paper.

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1 HM Treasury, "Freedom and choice in pensions", presented to Parliament by the Chancellor of the Exchequer, 19 March 2014.

2 FT Weekend, "BlackRock challenges U.K. pension providers", 19 April 2014

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## The Game Has Changed

Life companies relying on customer retention will continue to promote the longevity risk management benefits of annuities. However, to compete, providers must develop new retirement income products that better match an individual's specific retirement needs:

- » As with other Defined Contribution (DC) markets, drawdown will need to be made available to the mass market. It will have to be on a basis which does not expose savers to undue risk of outliving their retirement funds. For savers with smaller fund sizes, more efficient advice models are needed.
- » The U.K. will need to develop an effective market for deferred longevity protection, requiring new capital market solutions.
- » Offerings must expand to include investment vehicles with similar fixed-term and lifetime withdrawal guarantees, which have been successful in other developed retirement markets, such as the U.S. and Japan.

The incumbent U.K. life companies have a strong foothold in this market and the specialist capabilities to develop innovative new solutions. However, the U.K. retirement landscape – the products and leading providers – may soon look different from today.

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## Freedom and Choice: Free Lunch or Retirement Roulette?

The benefits of increased freedom and choice in retirement should be obvious. However, for the majority who will come to rely on their retirement savings to maintain an acceptable standard of living, it is not all good news. Retirees and advisors must face up to new risk management challenges which had previously been the domain of the life insurance actuary.

The implementation of this government policy is not without significant risk. Other large retirement savings markets where life annuities remain the predominant retirement income vehicle, are watching the U.K. closely. They want to see whether the U.K. makes any mistakes in implementing this new policy, and if so, to learn from those mistakes.

### Retirement is About Cashflows, not Returns

In the accumulation phase, the objective is to generate real growth over the savings term. Most commonly, allocation to a diversified portfolio of assets is used to control volatility and to "optimise" risk-adjusted return. A fall in the value of the portfolio in any one year is not so important. What is critical is the total accumulated return over the savings term. Losses can usually be recovered over time, either by recovering asset prices, or through additional payments.

In the decumulation phase, the savings objective is fundamentally different. Retirees care about generating income cashflows to maintain their required standard of living. Investment returns are not the primary concern.

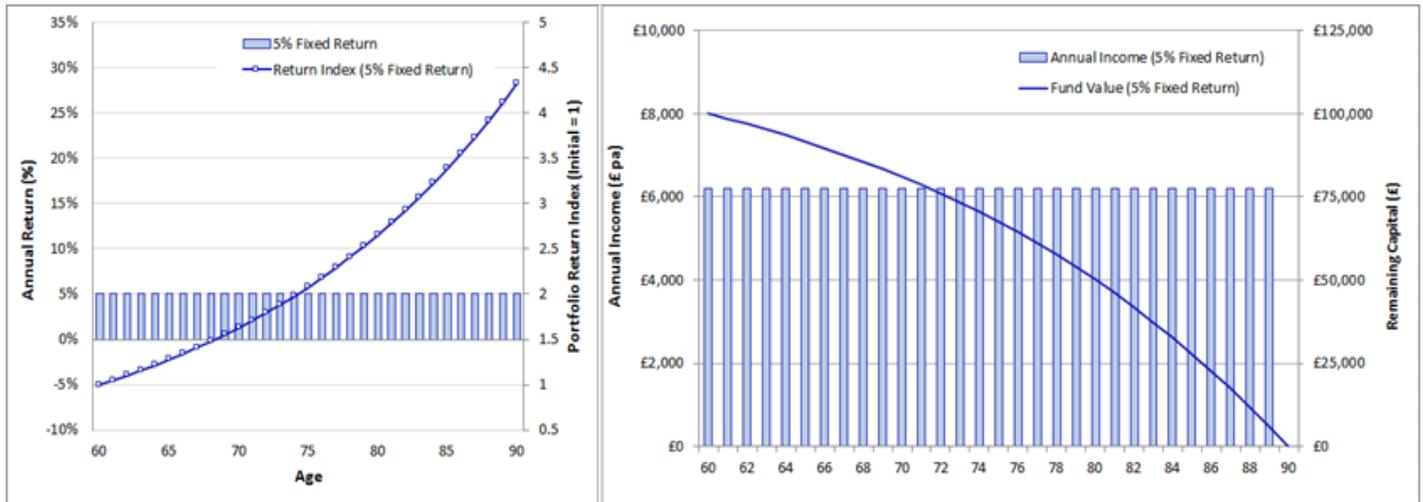
In other retirement markets, where drawdown is the predominant vehicle for retirement income, the primary risk is running out of money. Retirement savings can be exhausted as a consequence of living longer than expected (longevity risk), or by suffering poor investment returns (market risk).

Where an individual receives income from an invested portfolio, as well as from capital, the sequence of returns becomes critical to the retirement plan. Poor returns in the early years of retirement cannot be recovered by better returns later on.

### Sequence of Returns Risk: The Impact of Bad Timing

The following example demonstrates how retirement can become risky for the unwary. Take a retiree at age 60, with a fund of £100,000, seeking to generate a fixed income of £6,200 for 30 years. A "critical yield" or "fixed return" of 5% on the underlying investment portfolio will generate an income of £6,200 for exactly 30 years. After this point, the fund will be exhausted. This deterministic outcome is illustrated in Figure 1.

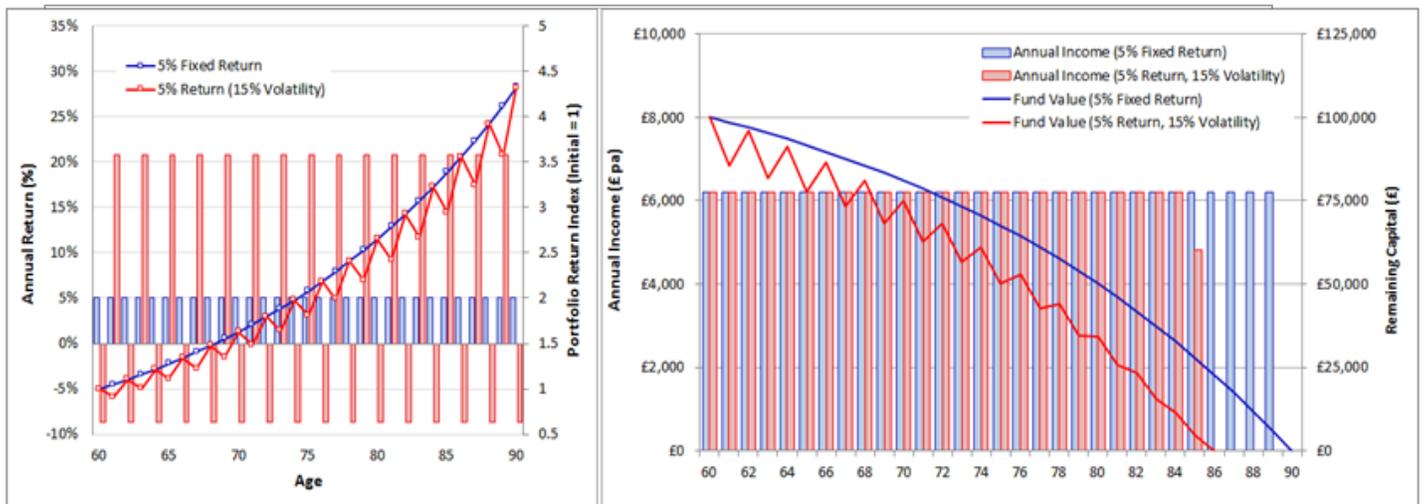
Figure 1 Generating £6,200 income for 30 years at a fixed return of 5% per annum



Unfortunately, contrary to the fixed rates used in most cash flow planning tools, 5% returns do not come in straight lines.

To provide clearer picture of what might happen with a 5% return, we simulated a sequence of variable investment returns, with a volatility of 15%. Importantly, the total return over the 30-year term is the same as before: 5% per annum. The red and blue lines on the left-hand chart in Figure 2 end up in the same place. However, reviewing the right-hand chart, the variable return scenario (red) shows our customer runs out of money 5 years earlier, at age 85.

Figure 2 Volatility: The impact of variable returns on retirement outcomes

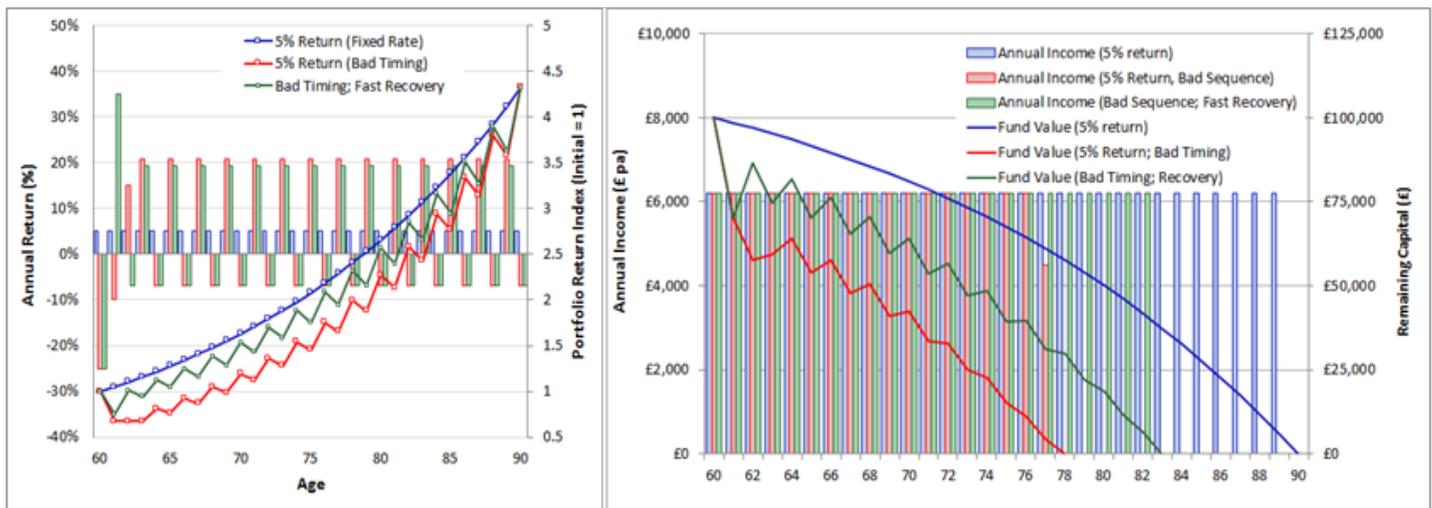


Volatility is typical in most investments, other than a bond portfolio perfectly matched to the target retirement cashflows. However volatility is only part of the retirement income lottery. Importantly, the scenario used in Figure 2 does not capture the impact of a bad sequence of returns.

Another scenario where our retiree would be unlucky is when the portfolio loses 25% in value in the first year of retirement, but later recovers, so the total cumulative return remains 5%. The red line in the left panel of Figure 3 depicts this scenario. We see on the right-panel that the retirement savings run out around age 77, lasting only 17 of a 30-year term. The retiree is drawing down the same level of annual income (£6,200) from a diminished fund. By the time the higher returns kick in, there is a reduced level of residual capital, failing to make up the savings shortfall.

Even believers of strong "mean reversion" in asset prices will be burned by this sequence of returns risk. The green line in Figure 3 uses the same 25% loss in year one. It assumes an immediate 35% bounce in year 2, followed by stable asset price growth over the remaining retirement term. The strong bounce helps to a modest extent, but savings still run out seven years earlier than planned, at age 83.

Figure 3 Sequence of Returns: The Impact of Bad Timing



Other than the fixed return case in Figure 1, all the other cases have the same average return (5% per annum) and volatility (15%) characteristics. However, under these different scenarios the fund could run out at any point between age 77 and 86.

Well-informed retirees will benefit from increased freedom and choice, and the range of innovative new products that will arrive in our new market. However, for those retirees who are most reliant on their savings to support their standard of living in retirement, this freedom may become a lottery. Product providers and advisors need to develop tools which can help retirees to manage these risks effectively.

## New Solutions for Retirement: From Asset Allocation to Product Allocation

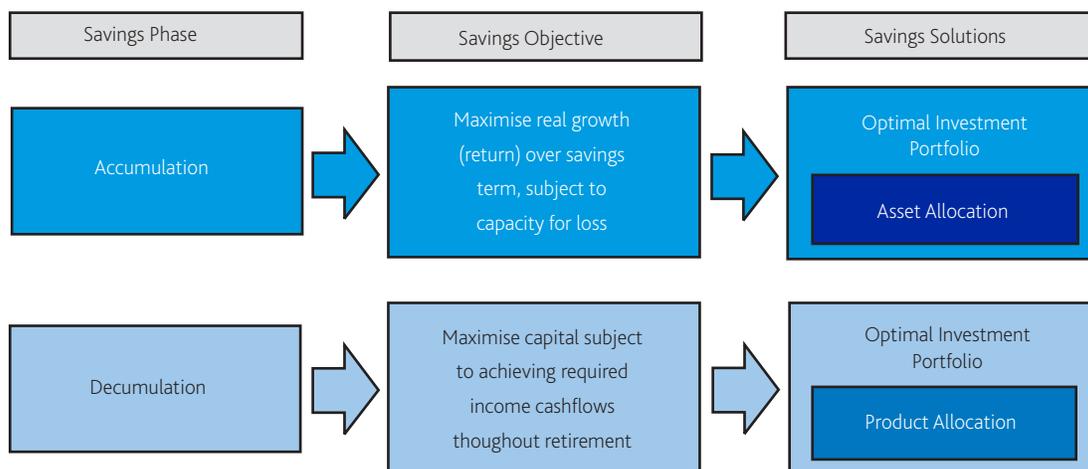
Diversified asset allocation can control volatility and potential losses when accumulating wealth, but will not control sequence of returns risk in the decumulation phase. The only way to manage this risk is to use some form of cash flow protection. Examples include bonds with coupons matched to required cash flows, guaranteed investment products, or annuities.

In addition, retirees may want to maximise access to cash, or the potential for future capital growth, to support later life care, or a bequest.

Depending on the required income level, and other objectives, the "optimised" retirement portfolio is likely to include allocations covering:

- » A drawdown plan which will deliver the required income level over a specified term, or until death. This plan will likely include a bond allocation, or other cash-flow matched assets which provide a high probability that the required income level can be sustained.
- » In addition to the drawdown plan, a lifetime or fixed-term annuity may be used to support a minimum secure income level, or to reduce the risk of running out of money.
- » Deferred longevity protection, for example a deferred annuity, which will pay income if the saver lives beyond the term of the drawdown plan.
- » A diversified portfolio, invested according to the preferences for liquidity or capital growth.

Where in accumulation the focus is on optimizing asset allocation, effective solutions for managing risk in retirement must focus on identifying the optimal product allocation.



Existing risk rating solutions have been designed to measure and compare risk across different investment options (asset allocations) in an accumulation context. However, these existing solutions are not well designed to help us understand risk in different retirement options (product allocations).

## Beyond Volatility: A New Framework to Assess Risk in Retirement Options

While annuities may remain an important building block for many retirement plans, many more savers will use investment drawdown to generate income in retirement. Knowing Fund A has a volatility of 14% while Fund B has a volatility of 8% reveals nothing about which option is best for a particular individual.

We need a coherent basis for assessing risk and suitability that adequately captures the longevity and market risks associated with retirement:

- » How can we identify retirement solutions best suited to a client's specific income needs?
- » Does the customer understand and accept the risk of running out of money, or having to make significant reductions in future income levels?
- » How can we compare risk across different investment options?
- » What information should be communicated to demonstrate suitability of the recommended strategy?

Volatility is the existing investment industry standard for measuring or comparing portfolio risk, and is the basis of many risk rating platforms. However, volatility takes no account of the client's retirement income needs. If volatility and fund risk ratings are of limited value in an accumulation savings context, they will be dangerously misleading when assessing retirement options.

Given the distinct and complex risk management challenges facing savers and advisors, the industry needs to develop new tools for evaluating capacity for loss. They need to ensure capacity for loss is aligned with suitable product choices. Moody's Analytics have developed a retirement dashboard, which provides a summary of the risks of different retirement options, in relation to client needs.

## Capturing Risk in Cash Flow Planning: Developing New Retirement Advice Models

Cash flow planning solutions are widely used in the U.K. in relation to retirement planning, where the key objective is to manage an income cash flow. As shown in Figure 1, a cash flow planning tool will produce a projection of future net assets and cash flow position, given a withdrawal profile and a rate of return.

Most tools allow the user to adjust the fixed return assumption, to illustrate how the outcome changes in good or bad markets. The current Financial Conduct Authority (FCA) projection rules reinforce this deterministic approach. They mandate a fixed intermediate rate of return (no more than 5% before charges), together with fixed flanking rates at +/- 3%.

Advisors and retail investors will interpret the output from these illustrations as representing the likely range of possible outcomes, or "what I might get back." However, these tools typically provide no information as to the likelihood, or probability, of experiencing such good or bad markets, or something more extreme. One cannot use a fixed return cash flow projection to make an informed decision as to whether an investment matches the client's capacity for loss.

We have illustrated that it is not so much the total rate of return which creates risk, but the sequence of returns. Cash flow planning tools that use fixed return assumptions will underestimate the risk of running out of money, and overestimate the sustainability of the retirement plan.

In the U.S. retirement market, the standard advice tools for assessing risk, for comparing options and demonstrating suitability, focus on the risk of failing to meet the client's cash flow needs:

- » Probability of running out of money
- » Potential size of any future income shortfall

This approach, uses both historic and Monte-Carlo simulation, and is in stark contrast to volatility-based risk ratings and fixed-rate projections and cash flow planning tools commonly used in the U.K. market. Moody's Analytics have been providing probability-based retirement modeling solutions for many years.

## Drawdown Review Analyser

How sustainable is your client's retirement?



A move toward this type of advice model would provide a more objective and consistent basis for aligning retirement options with client cash flow needs. Technology allows this model to be scaled to meet much broader demand and supports ongoing review and client engagement, on an advised or direct-to-consumer basis.

## Financial Guidance at Retirement

According to the budget statement to the U.K. Parliament, guidance at retirement should be free, impartial, of consistently good quality, and face-to-face. It should cover the individual's range of options, and allow them to take action; seeking further advice or purchasing a product. What is included in guidance at retirement, how it is delivered, and how it relates to fee-based advice has been the subject of much commentary.

There are significant new risks and increased complexity introduced by freedom and choice. The delivery of effective retirement guidance services could become a key factor in the successful implementation of government policy.

## What constitutes "good quality" guidance?

The barrier must be set sufficiently high, and should focus on retirement outcomes, rather than product features. Any guidance must incorporate a minimum level of information that will enable a client to make a decision. Guidance must take into account the range of retirement options, including investment and life insurance. Information provided as part of the guidance process must act as a basis for the customer to compare the risks and suitability of the different options, in relation to their own retirement needs.

Moody's Analytics have developed a retirement dashboard, which provides a summary of the risks and benefits of different retirement options, in relation to client needs.

## Guidance must contain clear signposts for appropriate advice services

Agencies involved in the provision of guidance must offer an effective gateway to a range of segmented retirement advice services. There should be a significant opportunity for advisors who can develop their models to service this new market, and can work with the agencies involved in delivering free guidance. For example, it is possible that the nascent development of online advice solutions could offer a gateway between guidance and full advice. Without such a gateway, then at best guidance may become meaningless, and at worst lead to poor retirement planning decisions and significant customer detriment.

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