The accumulation and decumulation of private retirement wealth: Policy Issues

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* Drawing on much recent work from the IFS – I am very grateful to colleagues and ex-colleagues Rowena Crawford, Jonathan Cribb, Carl Emmerson, Heidi Karjalainen, Laurence O'Brien, Zoe Oldfield, Gemma Tetlow

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Overview

- Private provision for retirement is becoming increasingly important around the world, not just in anglophone countries
  - Pensions are key, but anything else that smooths consumption into retirement is also relevant here: retirement savings and accounts, health insurance, long-term care insurance
- Policymakers want to know how to regulate/design these institutions, and how to design the public institutions that interact with them
  - To avoid future inequality and poverty amongst retirees and/or future liabilities on the public programmes

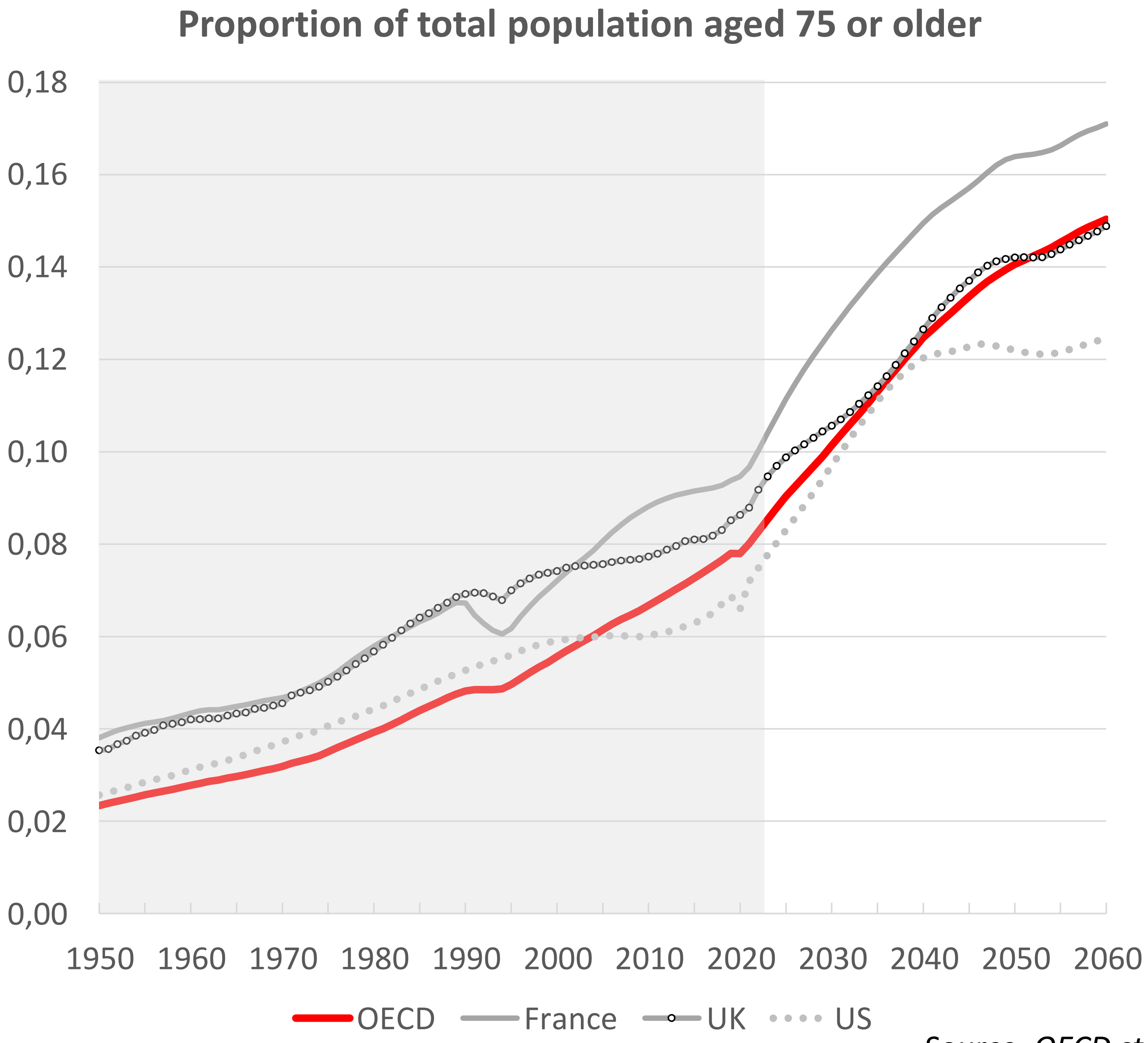
Overview

- Accumulation and decumulation phases are both important
- I will cover both here, but much less has been written on decumulation. Yet it is becoming increasingly important:
  - Future retirees will be decumulating for a long time
  - And decumulation choices and decisions will need to be made at increasingly older ages
- Analysis of UK, which has been at forefront of this trend
- Some common broad themes, policy issues and evidence gaps emerge

Demographic Background

The proportion of the population over 60 has been rising since around 2010 as the baby boomers reached retirement age.

But we are only now entering the era of rapidly rising numbers of *older* old people



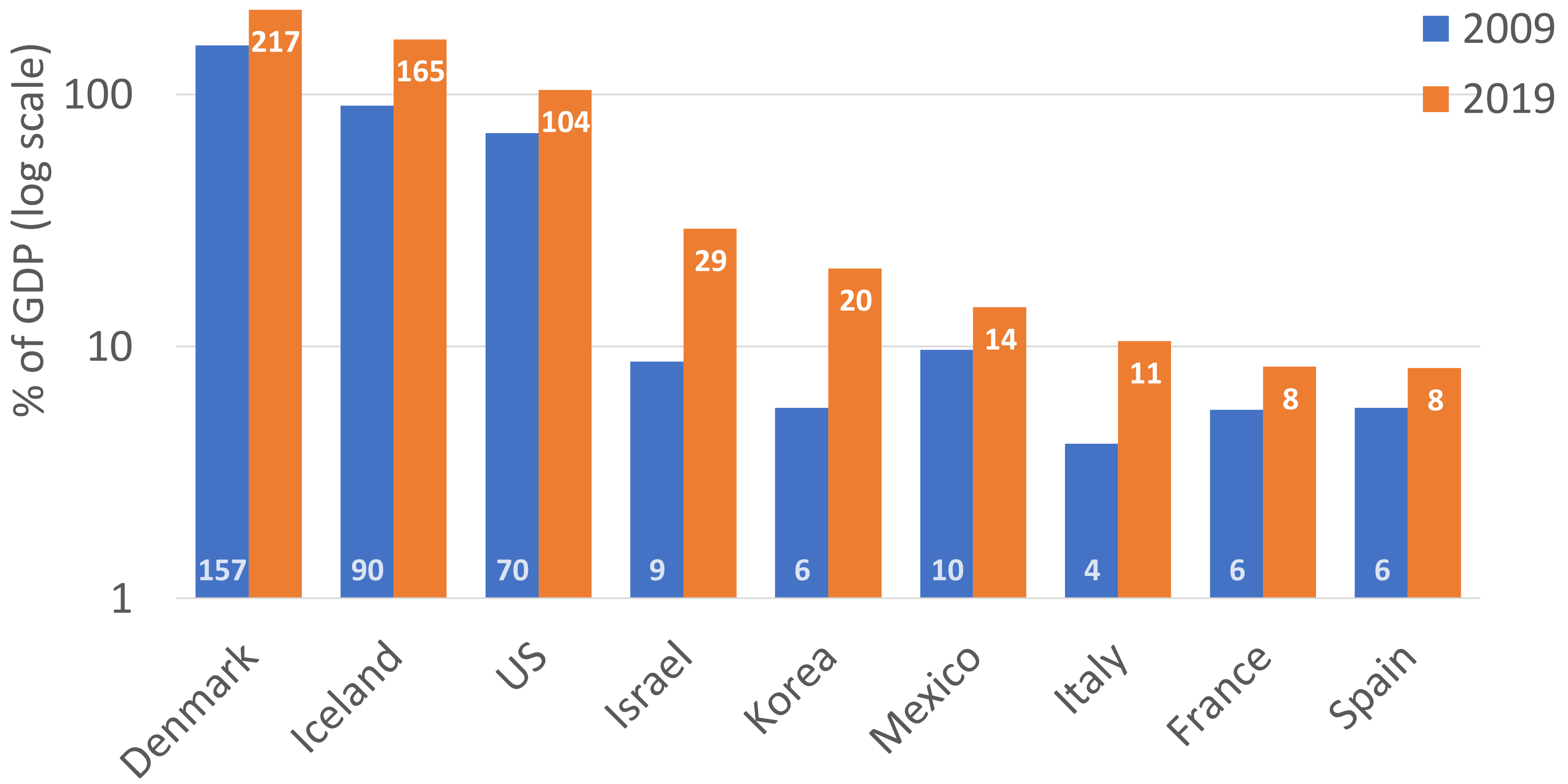
Source: OECD.stat

1. Accumulation

The rise of Defined Contribution pensions

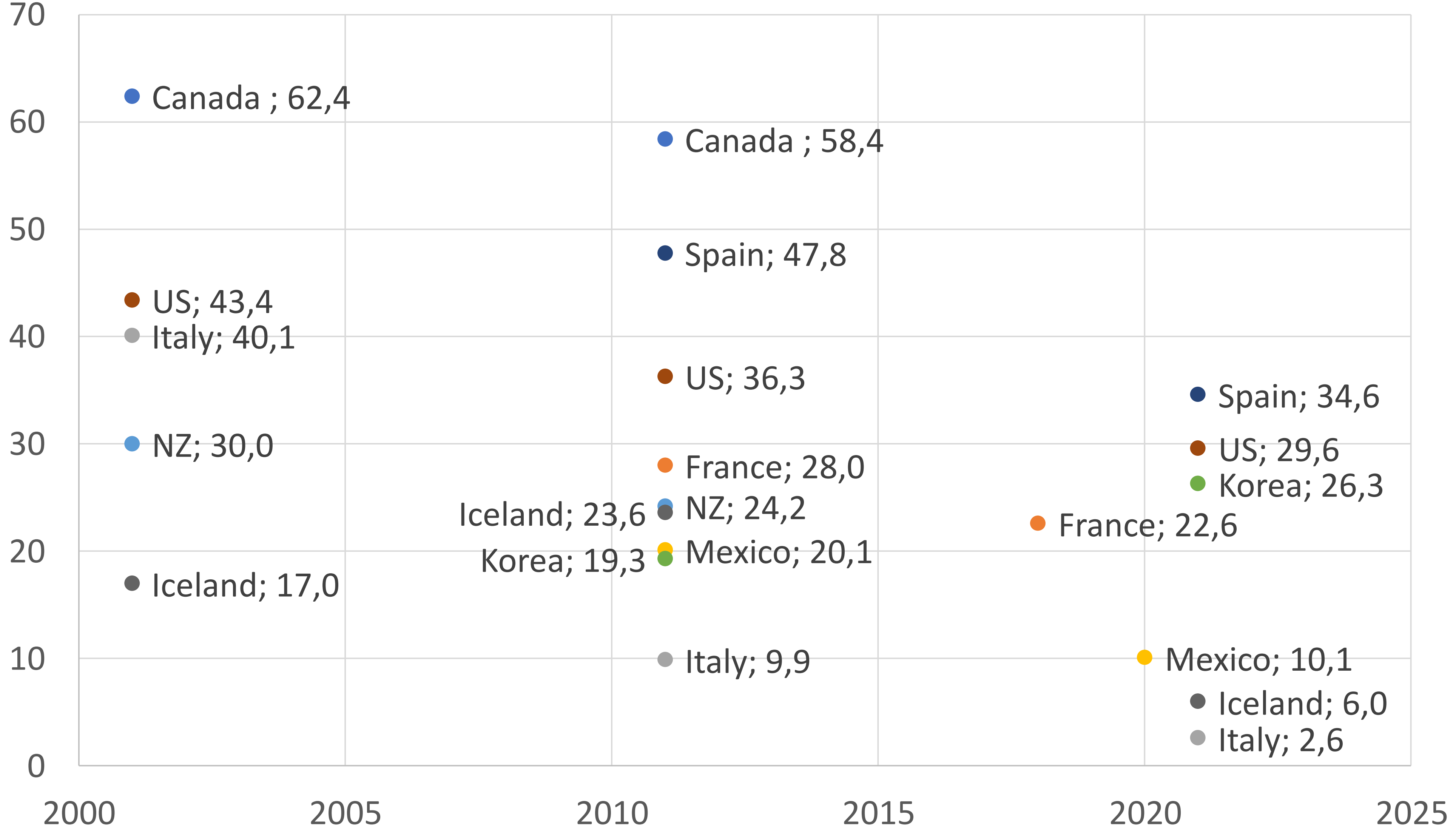
- Defined Contribution (DC) pensions have been the main way in which private retirement wealth accumulation has increased
  - As a supplement to public pensions
  - And as employer pensions have gradually switched from DB to DC

Defined Contribution pension assets becoming more important around the world



Source: OECD Pension markets in focus, 2020

Share of pension assets in DB (%)



Source: OECD Pension markets in focus, 2022

The rise of Defined Contribution pensions

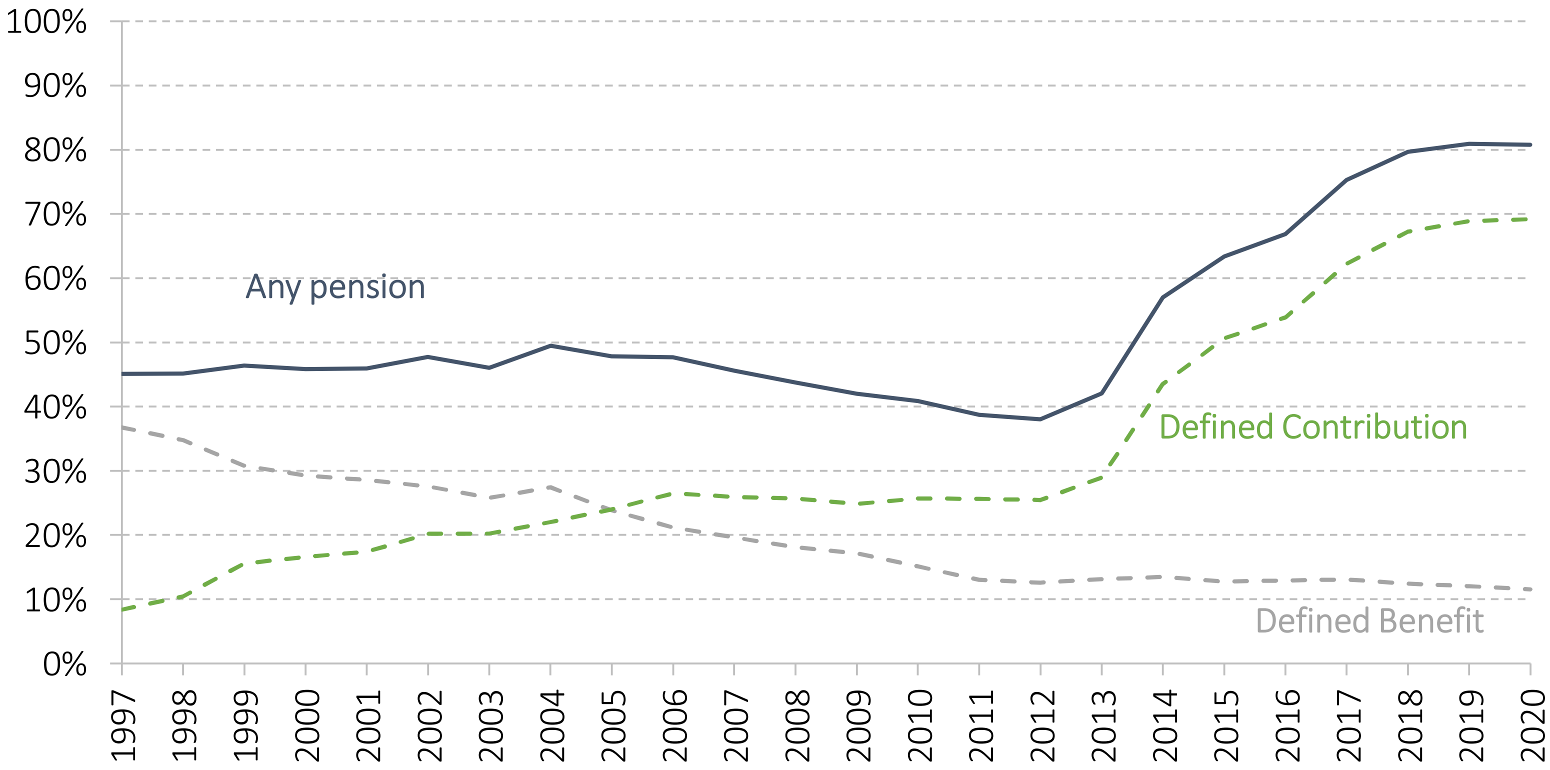
- Defined Contribution pensions have been the main way in which private retirement wealth accumulation has increased
- Much analysis of the ‘adequacy’ of retirement saving, and the retirement savings puzzle. Are people saving enough? (in total, and in their DC pensions)
- Also key work on the importance of financial literacy in choices
- Led to a more recent focus on ‘nudge’ type behavioural policies

The rise of AutoEnrolement (AE)

- Auto-Enrolment changes the defaults for pensions, so individuals need to opt out, rather than opt in
- First studied in large US employers (Madrian, Beshears, Choi and Laibson)
- Rolled out in UK from 2012, and now in some US states. Currently being planned in Germany, Ireland, Poland, Turkey. AE savings scheme in New Zealand (KiwiSaver)

AE had a huge impact on pension participation in the UK – driven by DC schemes

Proportion of private sector employees participating in DB and DC schemes



Source: Adapted from Cribb, Emmerson, Johnson, Karjalainen and O'Brien, 2023. Figure 5.

The causal effects of AE in the UK

- The timing of the roll-out is being used to get causal estimates on pension participation and contributions

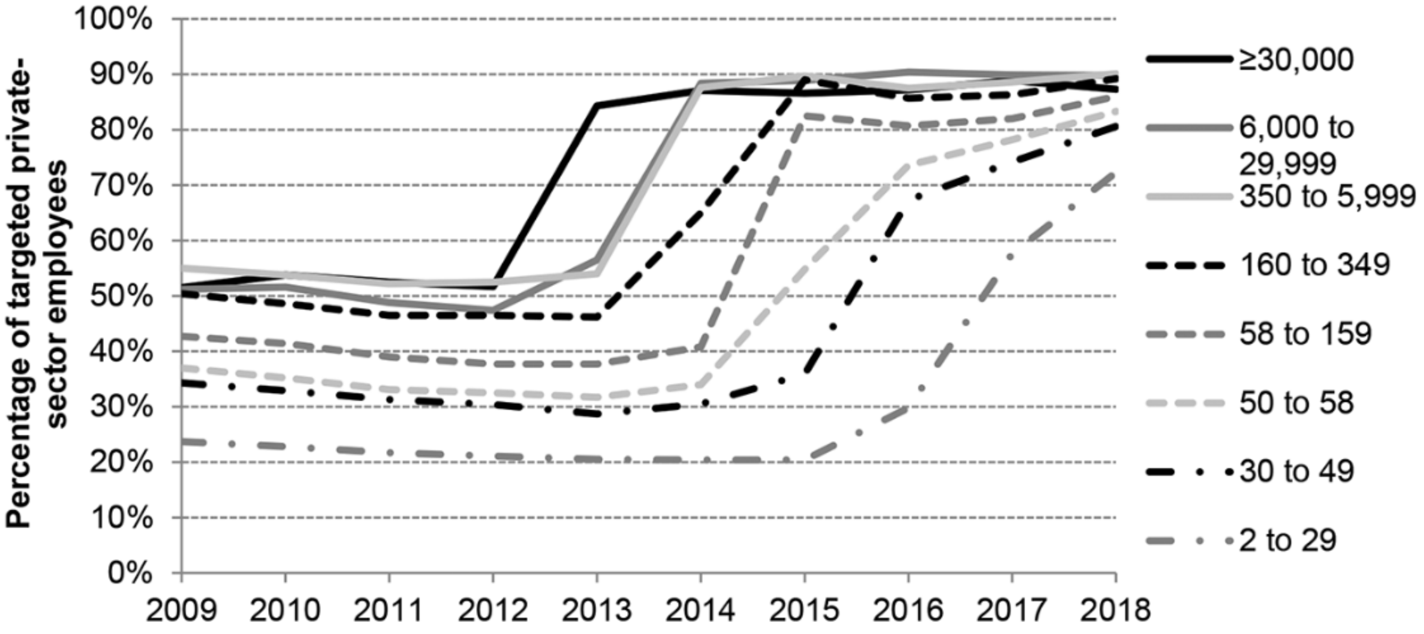


Figure A1. Workplace pension participation rates among private-sector employees targeted for automatic enrollment, by employer size in 2012. Calculations are authors', using data from the ASHE.

Source: Cribb and Emmerson 2021 NTJ

The causal effects of AE in the UK

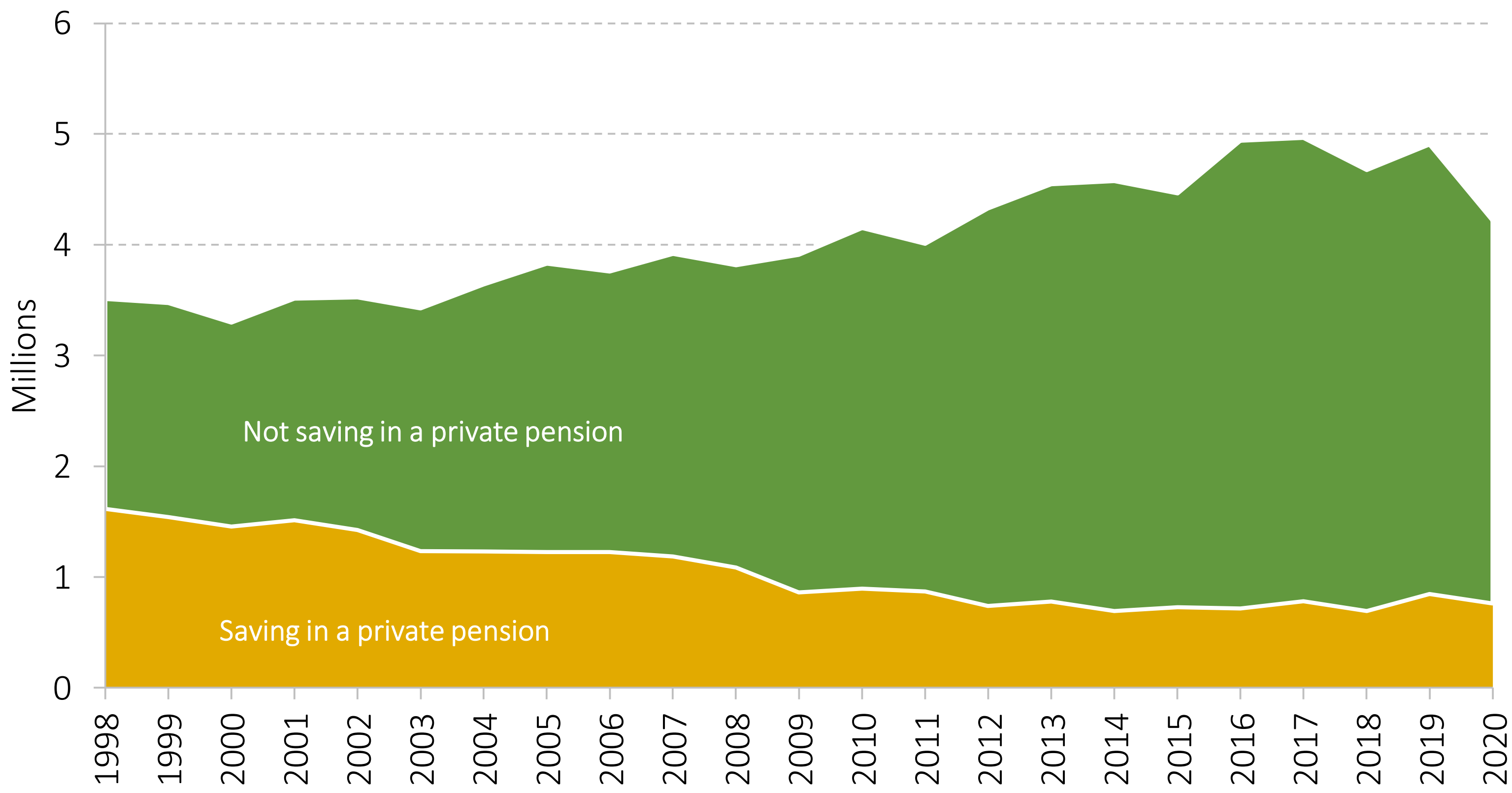
- The timing of the roll-out is being used to get causal estimates on pension participation and contributions
- Increased participation by 37 ppt in large employers; by 44-50 ppt in small employers, but post-AE pension coverage was still ‘only’ 70% in small firms
- Increased contributions by 1% of earnings in large employers; by 2% of earnings, £45 per month, in small employers
- Also some observed effects on non-eligible employees in AE firms
- Differences between large and small firm effects not explained by observed worker characteristics nor the reduced generosity of employer contributions in small firms

Ongoing policy issues with AE in the UK

- Crowd out: We see more in DC pension wealth but do we see more retirement wealth?
  - Potential increases in household debts
  - Offsetting reductions in other savings
  - What has happened in the recent 'cost-of-living' crisis?
- AE in the 'new labour market'
  - The 'small pot' problem
  - How well is AE working for employees in small firms?
  - Still no coverage for self-employed. What about gig-economy etc.

Low private pension saving for the self-employed

Number of self-employed people participating, and not participating in a private pension scheme, 1998-2020



Source: Adapted from Cribb, Emmerson, Johnson, Karjalainen and O'Brien, 2023. Figure 7.

Accumulation: Summary

- Cohorts of retirees are already arriving at retirement with more DC wealth than their predecessors
- This will increase rapidly for future cohorts given trends in AE and potential future reforms
- More DC wealth that will need to be managed
- What policy issues will this raise?

2. Decumulation

Decumulation: Introduction

- Retirements are going to be very long (for some)
- Retirement annuity and other related insurance-type products (health insurance, longterm care insurance, life insurance) are getting increasingly complex
- Cognitive issues may well be important for some. But work on financial capabilities has not really focused on decumulation.
- There are also potentially greater informational asymmetries when decision makers are older

60 year olds are now very likely to survive to their mid 80s and early 90s

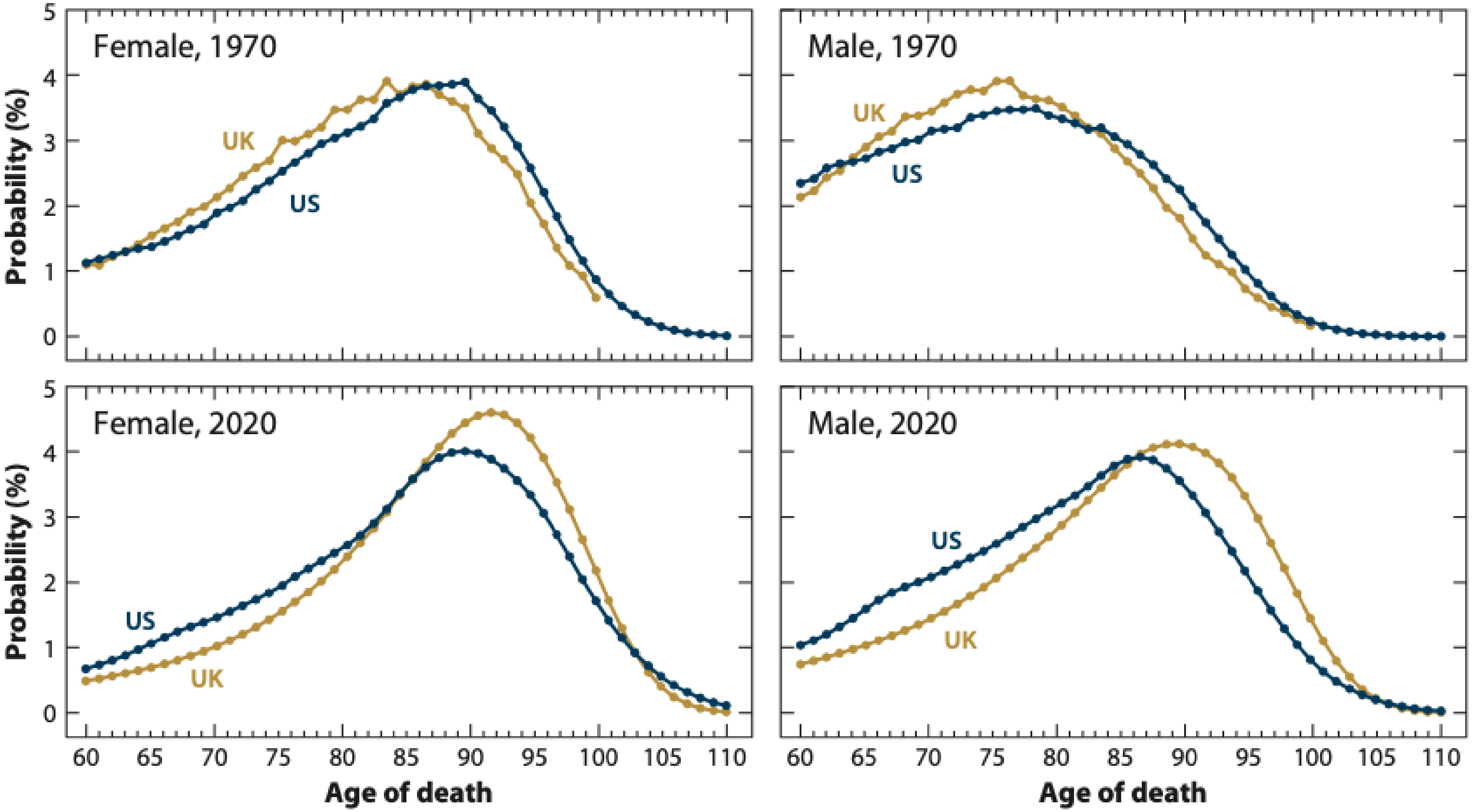
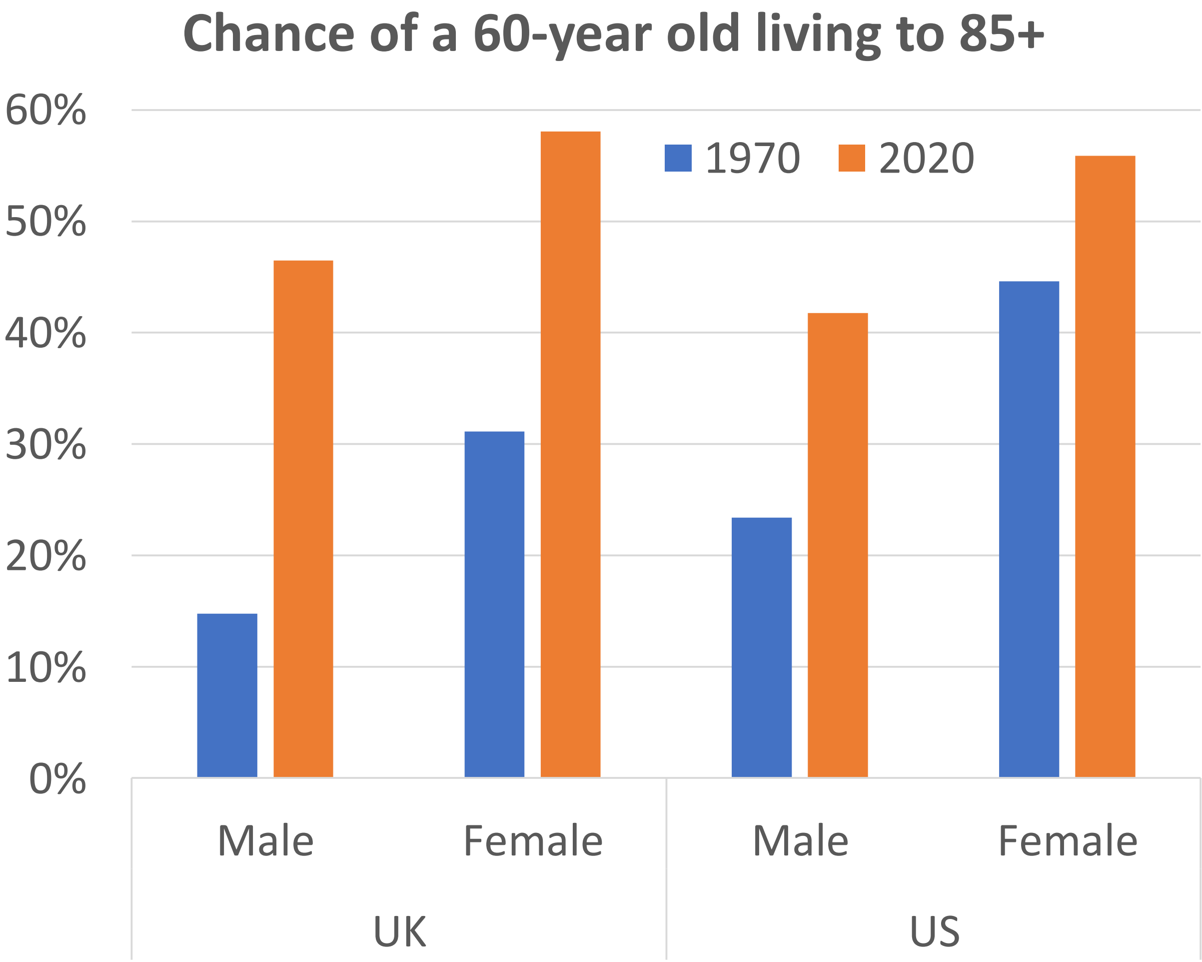
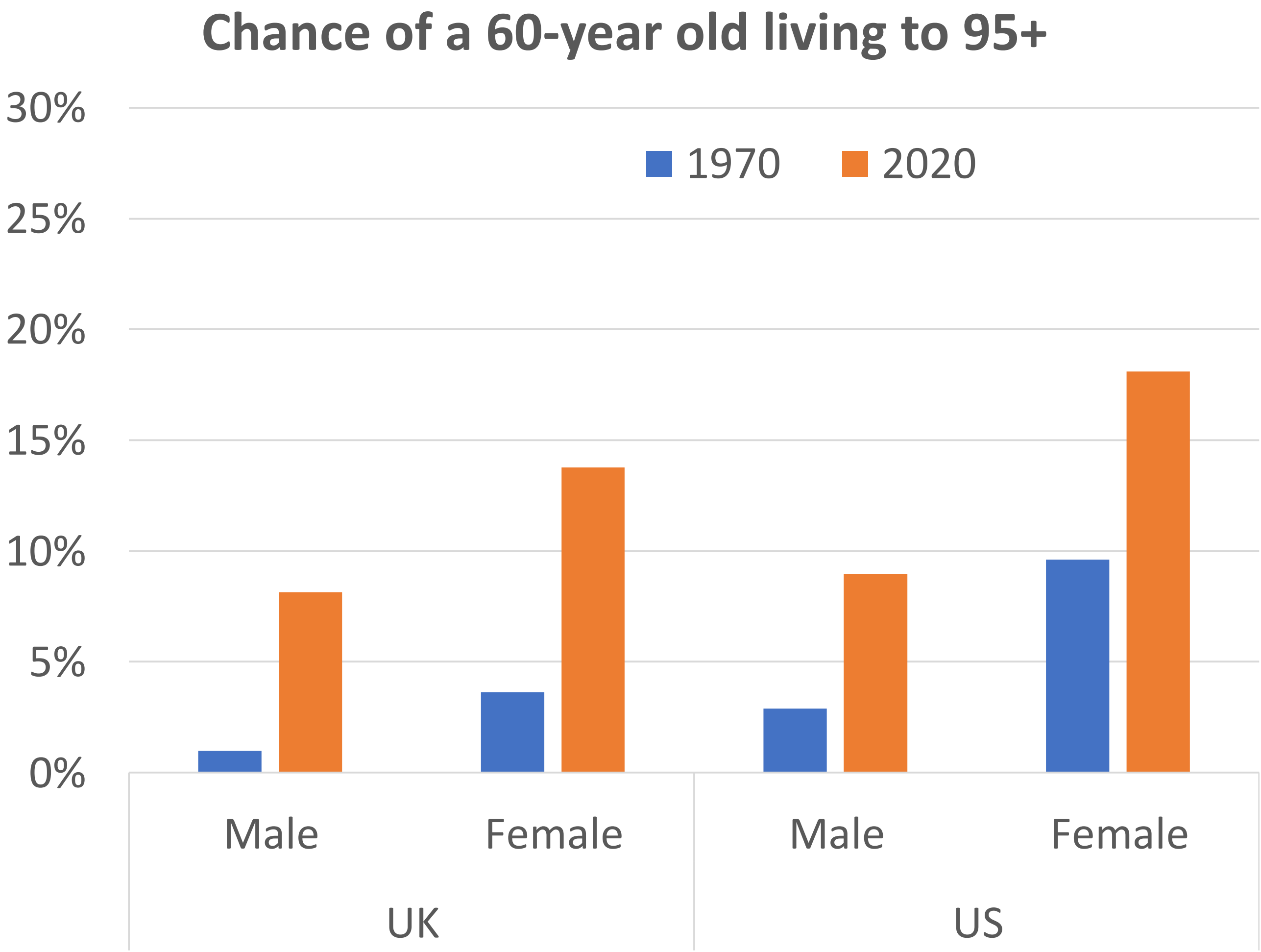


Figure 3

Distribution of expected age of death for individuals aged 60. Probabilities beyond age 100 are not available for the cohort reaching age 60 in the United Kingdom in 1970. US distributions are calculated from cohort life tables by Bell & Miller (2005). UK distributions are calculated from cohort life tables produced by Off. Natl. Stat. (2019).

60 year olds are now very likely to survive to their mid 80s and early 90s





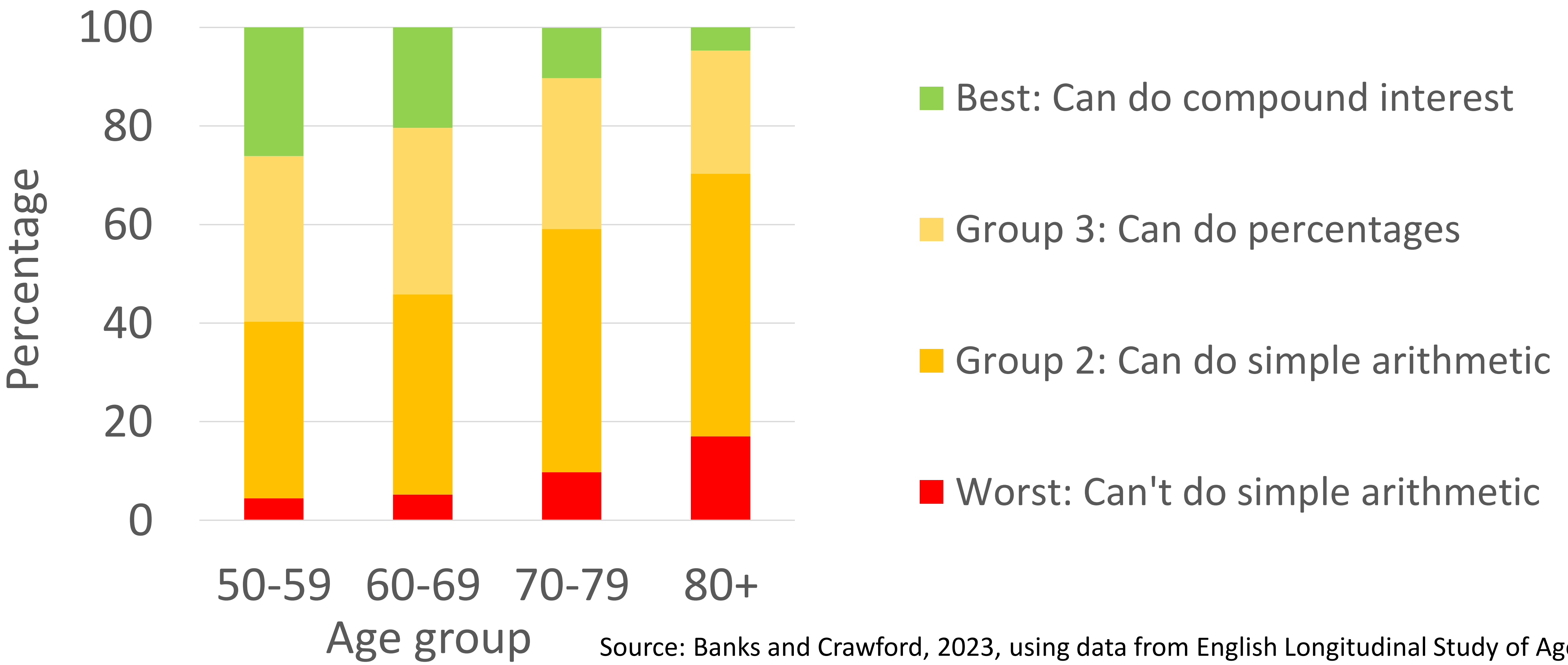
60 year olds are now very likely to survive to their mid 80s and early 90s

But there is a lot of uncertainty/heterogeneity:

One quarter of 66 year old men in the UK will die within 13 years. One quarter will survive more than 25 years

One quarter of 66 year old women in the UK will die within 16 years. One quarter will survive more than 28 years

Cognitive abilities decline at older ages



Source: Banks and Crawford, 2023, using data from English Longitudinal Study of Ageing

Aside: The HCAP initiative

- The Harmonised Cognitive Assessment Protocol is now being introduced into longitudinal ageing studies around the world
- Funded by US National Institutes on Aging
- Aiming to measure cognitive decline in much more detail, and to predict the onset of Dementia and Alzheimers Disease
- Very detailed assessments of subsets of study respondents (e.g. N= 1,500 in ELSA), repeated over time
- Data can also be analysed in context of other study data on family, care, health, wealth, etc.
- Should be very informative for financial decision making and outcomes as well

Consumption smoothing and annuity demand

- Wealth decumulation is slow post retirement
  - Particularly housing wealth
- People are reluctant to annuitise – the annuitization ‘puzzle’
- Optimal management of retirement incomes needs to take account of all risks and insurances – a portfolio problem
  - Including those around health and long term care expenses

- Life-cycle models with sufficient risk aversion, health expenditure risks and bequest motives are now beginning to be able to ‘explain’ the shape of *average* consumption trajectories post-retirement

Looking into annuitization in more detail

- We know the annuity market is thin. Using ELSA we studied DC pensions going from accumulation to withdrawal phase when annuitisation was ‘mandatory’
  - Relatively few observed individual characteristics other than existence of other annuities, can predict whether buys an annuity or opts to take income drawdown
  - Conditional on buying an annuity, financial literacy and cognitive numerical abilities both increase the likeliehood an individual shops-around rather than just annuitises with the same pension provider.
  - This on top of other results showing more numerate individuals were more likely to hold DC wealth in the first place

Drawdown of DC pension assets

- Most evidence from US, UK or Australia. All have different approaches and policies regarding drawdown
- In Australia and US, drawdown is pretty cautious
  - There is heterogeneity, but on average, decumulation is slow; many simply withdraw the minimum amount permitted/required, and only when they are required to do so
- UK: 'Pension freedoms'
  - Low levels of knowledge, and little use of advice on DC pension pots

Table 3b Sources of information on DC pensions among English pension holders aged 50–64

	Does not know DC wealth	Lowest 1/3 DC wealth	Middle 1/3 DC wealth	Top 1/3 DC wealth	All
No information	13%	11%	5%	10%	11%
Some information	88%	89%	95%	90%	89%
Of which:					
Accountant or independent financial advisor	4%	6%	7%	23%	8%
Scheme reports	62%	74%	81%	72%	68%
Pension representative	7%	6%	13%	9%	8%
Employer	24%	25%	14%	15%	22%
N	**646**	**176**	**172**	**173**	**1,167**

The table refers to individuals with defined contribution (DC) pensions aged 50 to 64 who were asked about their DC fund values. Sources of information do not sum to total in some cases because individuals can report multiple individual types of information. Authors' calculations based on data from English Longitudinal Study of Ageing, 2008/10 to 2018/19 (at **https://www.elsa-project.ac.uk/**).

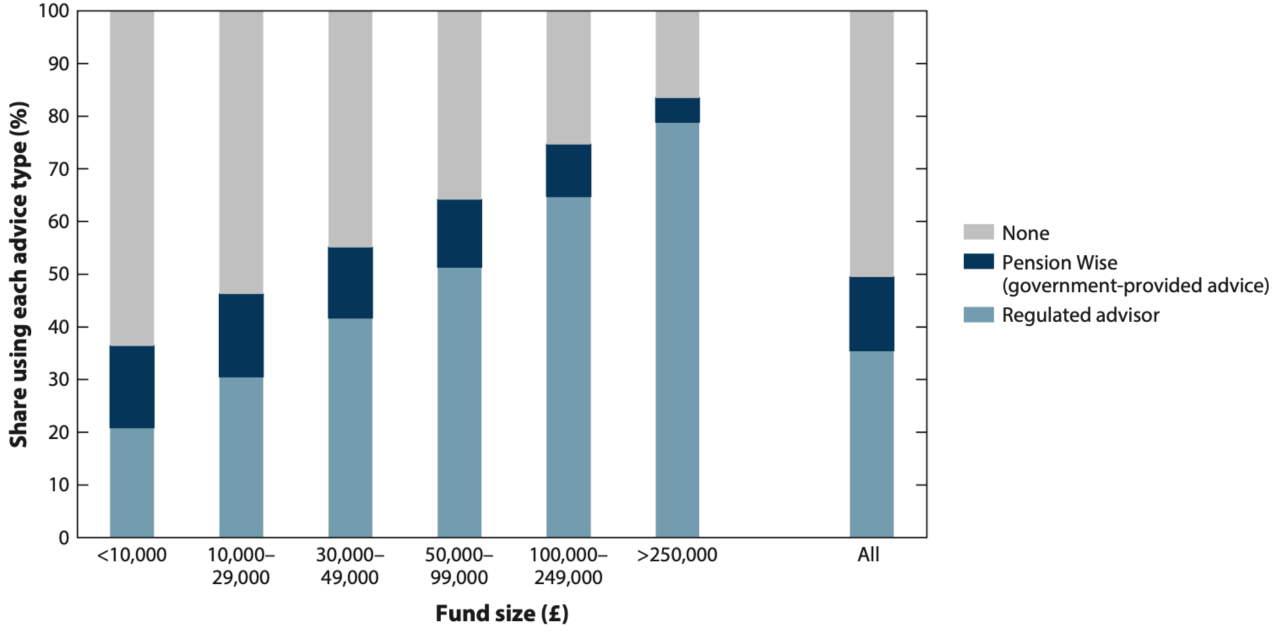
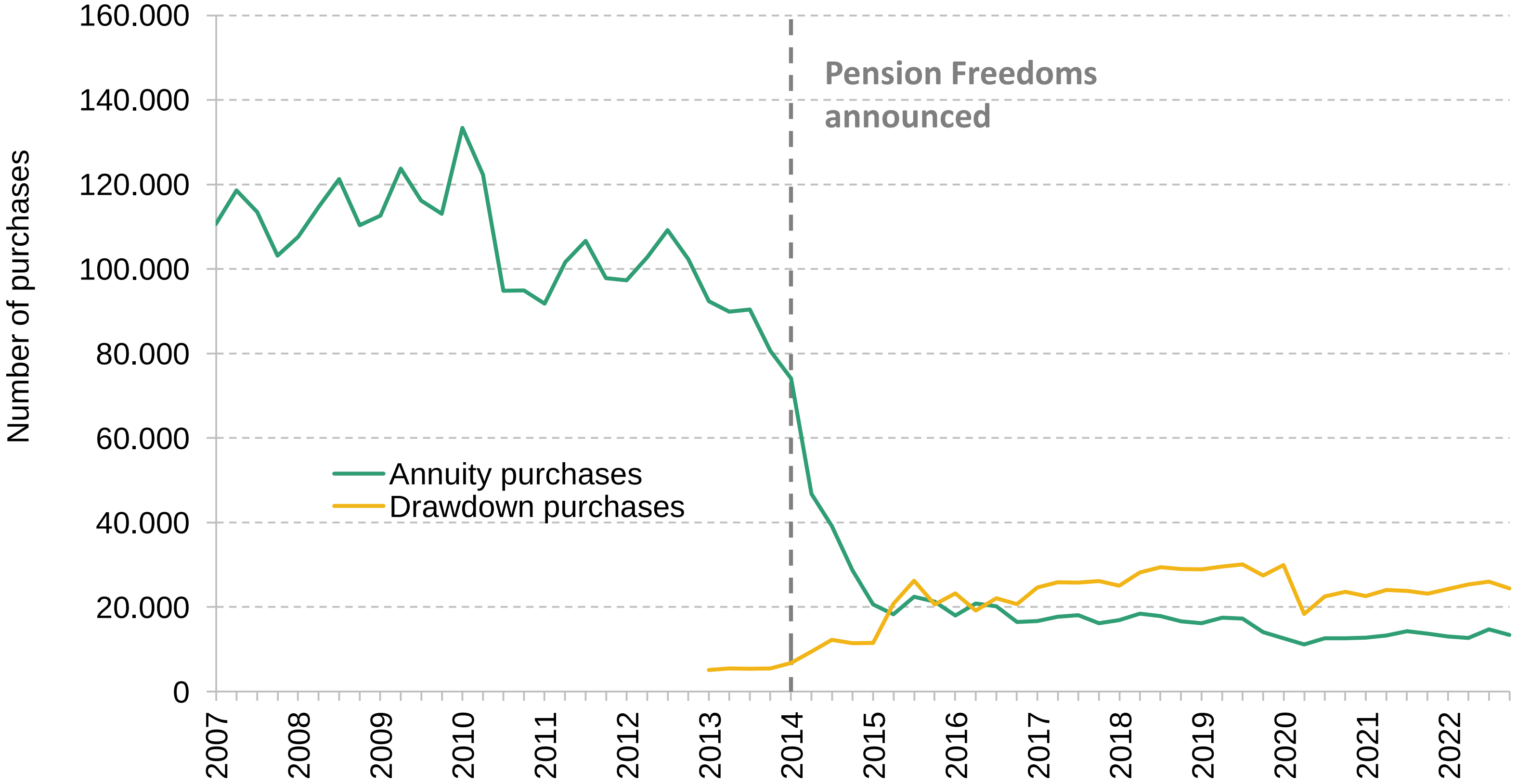


Figure 4

Use of advice for funds accessed for the first time in 2019–2020. Authors' calculations based on data from Financ. Conduct Auth. (2020).

Annuity purchases have fallen rapidly in the UK

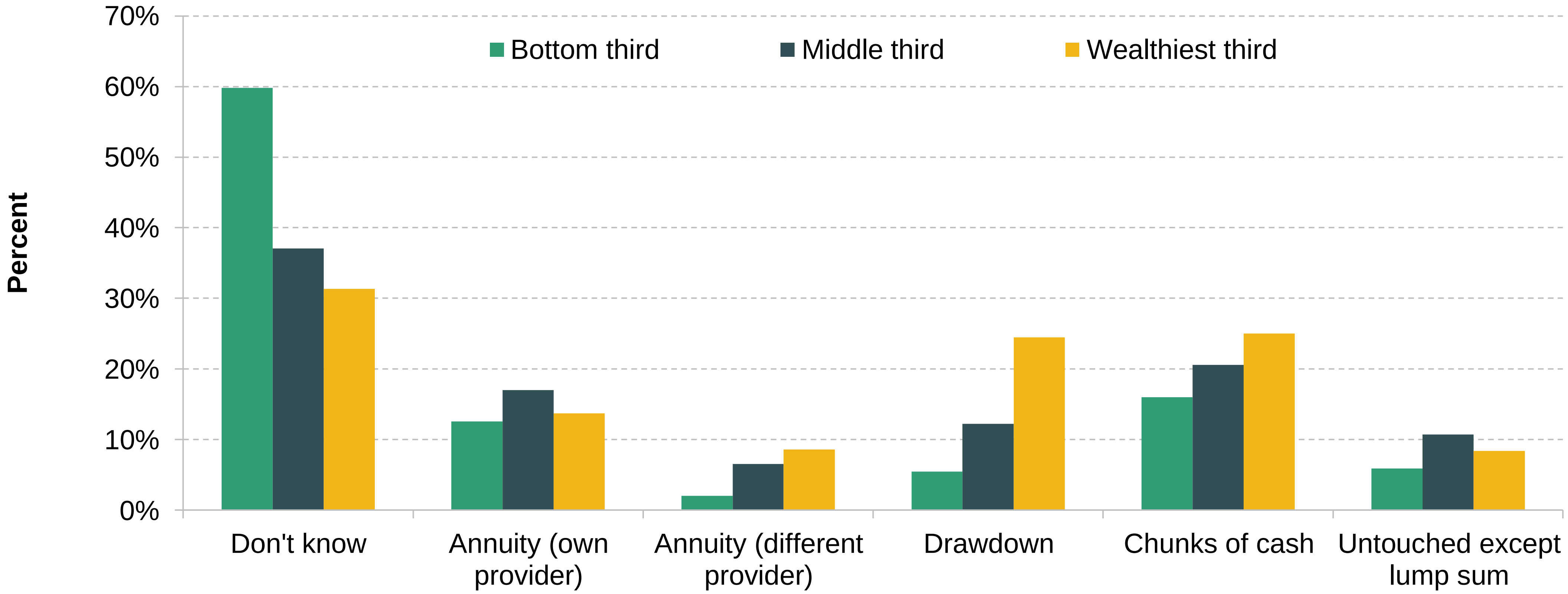
Number of annuity and drawdown purchases, 2007 to 2022



Source: Cribb, Emmerson, Johnson, Karjalainen and O’Brien, 2023. Figure 15.
Data from the Association of British Insurers (ABI), copyright of ABI.

Intended use of DC pension wealth,
by total individual wealth terciles

How do you plan to use (the rest of) your pension pot?



Note: Non-proxy respondents aged 50-64 with some unannuitised DC wealth. Wealth thirds defined among those with any DC wealth aged 50-64. Wealth is defined as total net private wealth at the individual level (excluding non-housing physical wealth and state pension).
Source: Karjalainen (work in progress) calculations using WAS Round 7 (2018–20).

Drawdown of DC pension assets

- Most evidence from US, UK or Australia. All have different approaches and policies regarding drawdown
- In Australia and US, drawdown is pretty cautious
  - There is heterogeneity, but on average, decumulation is slow; many simply withdraw the minimum amount permitted/required, and only when they are required to do so
- UK: ‘Pension freedoms'
  - Low levels of knowledge, and little use of advice on DC pension pots
  - Following the removal of annuitization requirements, drawdown of pension assets has been rather fast for some, and rather slow for others

Following ‘pension freedoms’, UK drawdown has been very heterogeneous

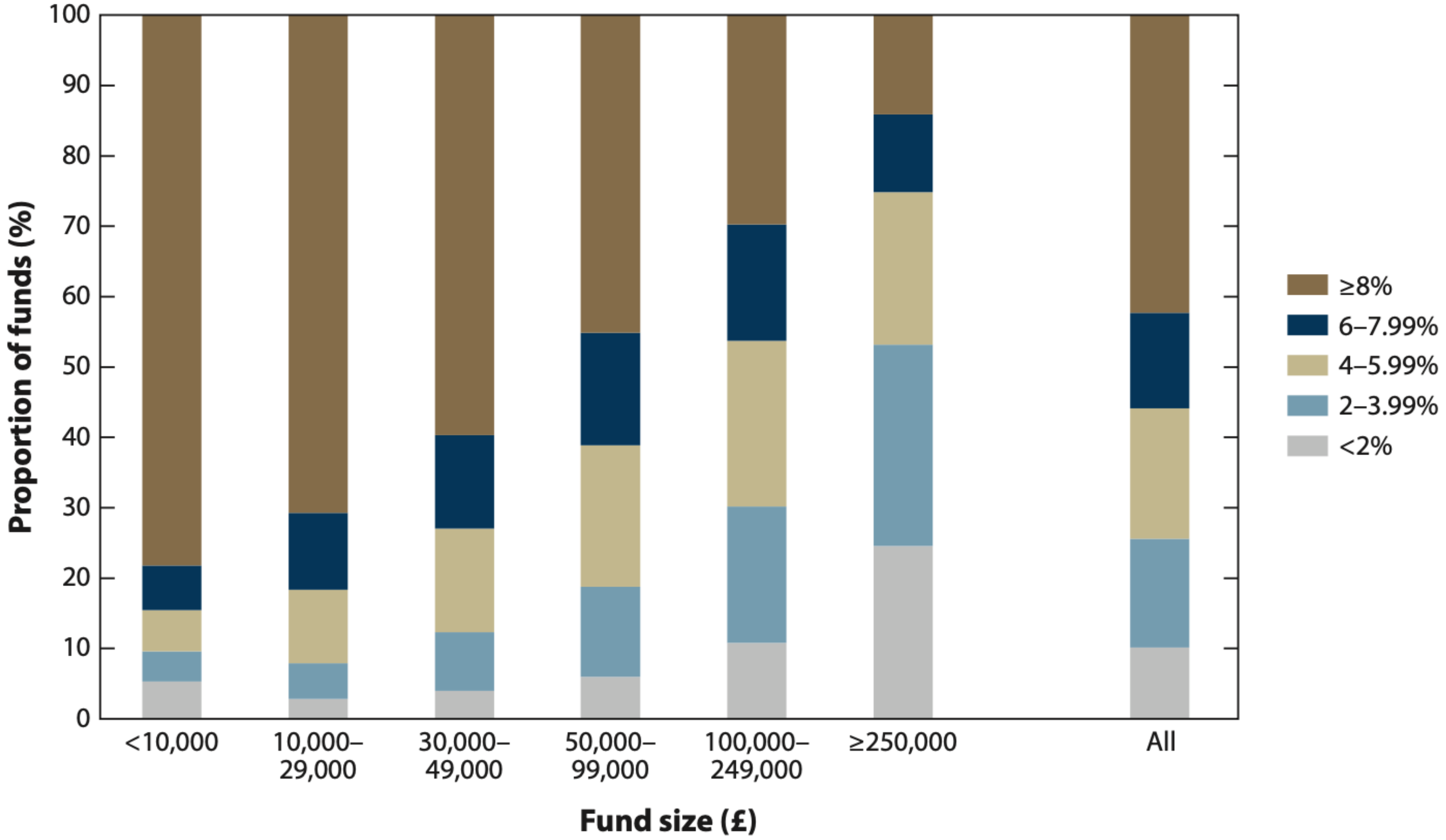


Figure 6

Regular withdrawal rates by fund size in 2019–2020. Authors’ calculations based on data from Financ. Conduct Auth. (2020).

Key issues for financial choices at older ages

- The optimal decumulation rate is complex and heterogeneous
- What information does the individual have?
  - About own underlying health and longevity risks
  - About the financial landscape- choices, opportunities, risks
- Declining cognitive abilities (and correlation with wealth, pensions)
- The use and nature of advice on decumulation
- Who makes, or helps make, decisions more generally?
- Financial capability, especially online
- Vulnerability to fraud

Conclusions

Conclusions

- The extensive DC / individual retirement provision literature implicitly acknowledged individual risks
- My reading of this literature was that this acknowledgement was more on the asset returns and asset price side than the decision making side
- And the decision making risks that were discussed were mainly on the accumulation side – financially less capable individuals not saving enough
- But there is now an urgent need for evidence on financial decision making at older ages when individuals are having to take complex decumulation and insurance choices

Conclusions

- Structural macroeconomic and consumption literatures need to start allowing for limited capacity in decision making. Requires more nuanced models
- Analyses of individual asset decumulation, annuitization and insurance choices, particularly when thinking about behavioural and financial literacy issues, should take overall portfolio and risks into account, it shouldn't be asset specific. Requires better data.
- More systematic work needed on older adults use of financial advice (government, IFAs, pension providers, employers) and on delegated decision making (incl. family members)
- Work on financial literacy and the sufficiency of cognitive abilities for financial choices needs to focus on late life as well as on working ages
  - e.g. with the ELSA-HRS type ageing studies detailed cognitive assessments (HCAP)

Conclusions

- At present, policies have to be designed and implemented without sufficient evidence on their welfare implications
  - use of defaults to encourage annuitization
  - changes to statutory withdrawal rates,
  - or even the encouragement of different forms of private pension savings such as more collective DC provisions
- Policy makers needing to act despite this lack of evidence should at least consider the **simplicity** and **stability** of retirement income options and of the insurance markets faced by retirees
- In order to create a planning and choice environment that is as robust as possible to financial decision-making errors and age-related cognitive decline

Thank you

Further details on the decumulation part of this talk available in Banks, J. and R. Crawford, 'Managing Retirement Incomes', *Annual Reviews of Economics*, 2022, 14: 181-204, https://doi.org/10.1146/annurev-economics-051420-014808

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