

PERSPECTIVES

SPEND MORE TODAY SAFELY: USING BEHAVIORAL ECONOMICS TO IMPROVE RETIREMENT EXPENDITURE DECISIONS WITH SPEEDOMETER PLANS

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ABSTRACT

This article examines how behavioral economics can be used to improve the spending decisions of retirees, using a *SPEEDOMETER* (or *Spending Optimally Throughout Retirement*) retirement expenditure plan that employs defaults within a choice architecture. The plan involves just four key behavioral nudges: (1) first, make a plan—ideally by being auto-enrolled into one or with the help of a financial adviser; (2) automatic phasing of annuitization, which is designed to tackle the aversion to large irreversible transactions and losing control of assets, and so allows the greatest possible degree of flexibility in managing the rundown of retirement assets; (3) capital protection in the form of “money-back” annuities that deals with loss aversion, that is, the fear of losing your money if you die early; and (4) the slogan “spend more today safely” that utilizes hyperbolic discounting to satisfy the human trait of wanting jam today, and to reinforce the idea that “buying an annuity is a smart thing to do.”

INTRODUCTION

In 2004, Benartzi and Thaler (2004) came up with the brilliantly simple idea of *SAVE MORE TOMORROW (SMART)* plans that exploit behavioral traits such as inertia, hyperbolic discounting,¹ and money illusion to increase retirement savings using automatic deferred salary sacrifice.² The concept worked and has been implemented, with certain modifications, in a number of countries. For example, in the United Kingdom, a new national pension plan called NEST (the National Employment Savings Trust) was introduced in 2012 (Pensions Acts 2007 and 2008). This will use auto-enrollment

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¹ This means that individuals use higher discount rates for more distant cash flows than they do for nearer cash flows, with the consequence that distant cash flows are relatively much less highly valued today than nearby cash flows.

² This is where a portion of future pay rises is diverted to the employee’s pension plan.

to increase retirement savings. Younger employees can therefore overcome a potential problem facing many of their older colleagues, namely, insufficient pension savings leading to poverty in old age, a phenomenon that is inconsistent with the predictions of the Life Cycle Model (LCM).³

Behavioral economists have identified some of the limitations of conventional economic theory caused by the failure to take human behavior into account. Richard Thaler and Cass Sunstein in their best selling 2008 book *Nudge: Improving Decisions About Health, Wealth and Happiness* define two very different types of consumers—"econs" and "humans." In a retirement expenditure context, "econs" are fully rational life-cycle financial planners. "Humans," by contrast, try to make the best decisions for themselves, but are subject to behavioral traits that limit their ability to implement their plans. Thaler and Sunstein believe that very few people are "econs" and their book provides examples of how to nudge "humans" into making optimal choices.

In simple terms, the aim of this article is to look at how "econs" would optimize their financial plans in retirement, and then to find ways to nudge "human" retirees into making optimal choices. Is there something akin to *SMART* plans to help retirees spend the money that they have saved during their working lives by being optimally "smart" through retirement?

As the Baby Boomers begin to retire, a different set of behavioral issues confront them, and reluctance to save is replaced by a reluctance to annuitize and the possible suboptimal drawdown of retirement assets. This article examines ways in which behavioral economics can be used to overcome the so-called "annuity puzzle," the reluctance of retirees to voluntarily annuitize sufficient of their assets to adequately hedge their longevity risk. We do this by introducing *SPEEDOMETER* (or Spending Optimally Throughout Retirement) retirement expenditure plans. We use the term *SPEEDOMETER* to reflect the fact that spending optimally is related to the speed with which assets are drawn down, and a *SPEEDOMETER* is a useful device both for measuring and influencing speed.

A *SPEEDOMETER* retirement expenditure plan helps retirees pace their spending throughout retirement in order to optimize their lifetime income to cope with retirement income shocks and their ability to make intended bequests by: (1) first, making a plan, either by being auto-enrolled into one as part of the retirement planning service offered by the plan member's company, or by using an online or telephone-based service providing generic financial advice, or, if wealth permits, involving a financial adviser whose role is to assist with making and implementing the plan, and conducting

³ The LCM, introduced by Ando and Modigliani (1963), is still the dominant model used by conventional economists. In the LCM, individuals are assumed to have the skills to allocate their lifetime income and assets over their life cycle in order to maximize the expected lifetime utility of the consumption stream that can be purchased with the income and assets, taking account of attitude to risk. In the absence of a bequest motive, accumulated savings are run down to zero at the time of death: individuals die clutching their last penny and never run out of money while still alive.

annual reviews;^{4,5} (2) managing *all* assets and income sources holistically to secure, as a *minimum*, a core inflation-protected income sufficient to meet the retiree’s “essential” needs for the remainder of their life;⁶ (3) using insurance solutions, when available and cost effective, to cover contingencies, and, where possible, maintaining flexibility by holding sufficient assets to meet uninsurable shocks (i.e., a “rainy day” fund); (4) using automatic, phased annuitization into “money-back,”⁷ inflation-linked, fixed, or investment-linked lifetime annuities or into variable annuities (VAs)—depending on the degree of risk aversion and wealth of the plan member—to secure an “adequate” level of lifelong income⁸ above the minimum if there is sufficient wealth to do so; and (5) offering a simplified choice architecture for managing any residual wealth with the aim of achieving a “desired” standard of living in retirement,⁹ while allowing part of the remaining wealth to be bequeathed at a time of the retiree’s choosing.

We believe the plan is suitable for all members of society, except the superrich, although the size of the minimum income level will differ depending on circumstances (e.g., health status) and the socioeconomic group to which the retiree belongs. Part 2 will be the most important part of the plan for the mass market with limited bequestable assets. The remainder of the plan is designed primarily for the mass affluent, although it might also have some relevance both for members of the mass market with some housing equity and for the high net worth segments of society.

A SPEEDOMETER plan is one that we believe an “econ” would choose. But we also need to recognize explicitly that most of us are “humans” and need an appropriate choice architecture, as well as some advice and nudging, along the lines of Thaler and Sunstein (2008), toward the optimal solution provided by the SPEEDOMETER plan. The plan recognizes that it is not a question of *whether* retirees should annuitize some of their wealth, but *when* they should do so.¹⁰ Retirees with modest wealth in excess of the optimal “rainy day” fund cannot really afford to take on investment and longevity

⁴ We believe that the plan is more likely to be executed by being auto-enrolled into it or by using a financial adviser unless the plan member is particularly strongly self-motivated.

⁵ SPEEDOMETER plans need to take account of the taxation implications on income, capital gains, and inheritance. They also need to take account of the interaction with means-tested state benefits.

⁶ We define “essential” income as the income required to cover the plan member’s minimum basic expenditure needs.

⁷ “Money-back” annuities are capital protected annuities and work as follows. On death, any excess of the original purchase price over the gross annuity payments already received is returned to the annuitant’s estate net of any tax. The guaranteed payment schedule with a “money-back” annuity involves a decreasing death benefit to ensure that the sum of the overall payments is at least equal to the original purchase price.

⁸ We define “adequate” income as the income required to achieve a minimum lifestyle to which the plan member aspires in retirement.

⁹ We define “desired” income as the income required to achieve the full lifestyle to which the plan member aspires in retirement.

¹⁰ Income from defined benefit (DB) schemes is recognized within the SPEEDOMETER plan and typically viewed as similar to an index-linked annuity. Retirees who are members of DB pension schemes are likely to have less flexibility around phasing and when they can start receiving their pension income.

risks, and therefore need to annuitize sooner rather than later in order to secure at least an adequate lifetime income. Those with more wealth can use annuitization to insure against their income falling below what they consider to be an adequate or even a desired level and to reduce the variability around the level and timing of the inheritance they pass on to their heirs; in particular, annuitization enables bequests to be made prior to death.¹¹ It is optimal for couples to annuitize later than singles. In short, a SPEEDOMETER plan with its optimal use of annuitization allows retirees to “spend more today safely.” In fact, it is analogous in the distribution phase of the life cycle to a SMART plan in the accumulation phase, although it is considerably more sophisticated, since it also deals with the optimal investment and longevity risk strategies in later life. Planning retirement income is complex, given the unknown and effectively uncontrollable time period over which consumption has to be spread. By contrast, in the accumulation phase, individuals can influence, at least to a degree, when they exit the labor market and are able to adjust their savings rate.

Although the article focuses on how to spend wealth optimally, it is important to recognize that the key foundation of any successful retirement expenditure plan is accumulating sufficient savings prior to retirement. Annuities are often blamed for poor retirement incomes when the root cause is not annuities—which recent studies¹² have shown offer good value (in the sense of having relatively high money’s worth¹³—but rather an inadequate retirement fund as well as reductions in the real value of state and private pensions.

The outline of the article is as follows. In the “Needs, Risks, and Financial Resources in Retirement” section, we examine needs, risks, and financial resources in retirement. The “Retirement Income Products” section reviews the range of retirement income products available. “The Optimal Use of Products and the Optimal Investment Strategy” section discusses the optimal use of these products for different market segments—the low affluent, the mass market, the mass affluent, and the high net worth—considering how, if retirees were behaving optimally, they would determine their optimal investment portfolio and their optimal age to annuitize, taking into account the desire to retain flexibility to allow for uninsurable shocks. “Why Do People Not Behave Optimally?” section looks at the barriers that need to be overcome in getting to the optimal level of annuitization, whereas the “Nudging and Choice Architecture” section discusses the choice architecture required to “nudge” retirees to make better financial planning decisions. The last section concludes.

Throughout, it is important to bear in mind the following definition of a pension plan: it provides retirement income security for however long the plan member lives (Bodie, 1990). If a plan does not do this, it should be classified as a wealth management plan, *but not* a pension plan. We believe that a SPEEDOMETER plan is more general than a simple pension plan, because it looks at all of a retiree’s assets and income sources and uses them optimally to maximize the expected utility or welfare of retirement

¹¹ This might be optimal in order to reduce inheritance tax or maximize the welfare of heirs.

¹² See, for example, Finkelstein and Poterba (2002) and Cannon and Tonks (2008).

¹³ The ratio of the expected discounted value of the annuity payments to the market price of the annuity. This will be less than 100 percent to allow for selection effects and annuity provider costs and profit. The money’s worth is one measure of the value for money of an annuity.

expenditure. We also believe that a SPEEDOMETER plan is more useful than a typical wealth management plan for two key reasons: (1) it explicitly uses annuitization and its timing to meet expenditure needs and to make bequests more effectively, and (2) it actively uses behavioral economics to nudge retirees to make the best decisions for their circumstances.

NEEDS, RISKS, AND FINANCIAL RESOURCES IN RETIREMENT

Consumption needs in retirement are neither smooth nor certain. Consumption expenditure in retirement typically exhibits a U-shaped pattern. First, there is a period of active retirement in which retirees do the things they promised to do, but did not have the time to do, while they were in work. Then, there is a period of inactive retirement: aches and pains become more prominent and eventually people cannot even be bothered to go out and buy a daily newspaper. Finally, medical, care and possibly nursing home expenses come to dominate expenditure. For some, maximizing inheritance is an important consideration.

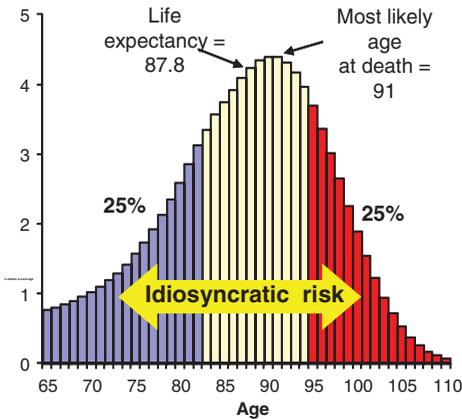
There are many adverse events that can impact even a well-structured retirement expenditure plan:

- Failure of private pension plans.
- Poor (i.e., low or negative) investment returns on household financial assets, leading to a depletion of wealth. Investment and reinvestment risks are present if retirement assets are held in anything other than conventional lifetime annuities. Stock market indices can fall by 10 percent or more in a single day—as we witnessed in 2008 during the Global Financial Crisis.¹⁴ Such falls can seriously damage wealth if a fixed income is still drawn from it.
- Low interest rates: not only does this affect the income received from bank deposits—the only financial assets held by a large percentage of retirees—there is interest rate risk when an annuity is purchased. If interest rates are low at the time of purchase, the annuitant will be locked into a permanently low annuity income.
- Period of high inflation: the purchasing power of money is reduced by half in 14 years with 5 percent inflation, in 7 years with 10 percent inflation. An index-linked annuity can protect against inflation, however.
- Changes in taxation and state benefit rules.
- Debts that have not been paid off while in work (consumer loans, outstanding mortgage, etc.).
- Loss of or inability to find postretirement work.
- Unexpected expenditure, such as a major repair bill.
- Unexpected needs of dependants or relatives.

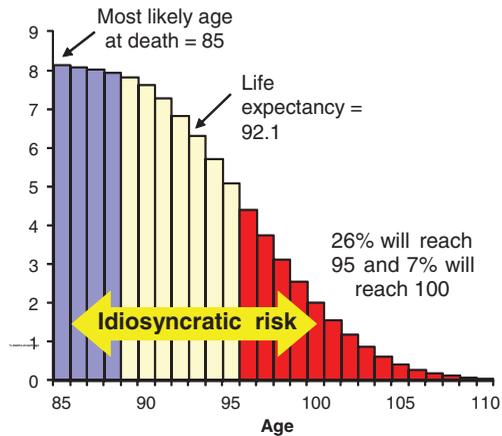
¹⁴ On October 10, 2008, the S&P 500 index fell 10.7 percent, whereas the FTSE 100 index fell 8.9 percent; the banks Morgan Stanley and HBOS fell by 25 and 19 percent, respectively.

FIGURE 1
Variability in Life Expectancy

Expected distribution of deaths: male 65



Expected distribution of deaths: male 85



Source: 100% PNMA00 2010 plus improvements in line with CMI_2009_M [1.00%].

- Ill health: this can affect not only the retiree, but the need to care for a partner can also have a major impact on retirement plans.
- Funding for long-term care.
- Divorce: this is on the rise for retired couples.
- Death of a partner: this can also have a major impact on retirement plans, especially if it results in a significant reduction in pension income.
- Longevity risk: this has two extremes—the risk of outliving one’s resources and hence the failure to leave an intended bequest, but also the risk of underspending in retirement and hence leaving unintended bequests. Individuals find it difficult to appreciate the variability of actual lifetimes around the expectation of life. Figure 1 shows that for typical 65-year-old males in the United Kingdom today, life expectancy is 87.8, but 25 percent will reach 94 and 8 percent will reach 100. A male aged 85 today can expect to live another 7.1 years to 92.1, 26 percent can expect to reach 95 and 7 percent to reach a 100.

Regrettably, there are fewer favorable events to help boost long-term retirement income. The main resources in retirement will be state benefits and allowances—both means-tested and nonmeans-tested—and private pensions, but some retirees will also benefit from:

- Significant nonpension financial assets.
- Housing equity release: this is probably the most important potential ladder for most owner-occupiers in retirement.

- Part-time working.
- Additional state benefits and allowances that can help offset some of the additional expenditure increases due to ill health, care needs, or higher fuel costs in old age.
- Life, critical illness, health, and long-term care insurance.
- Inheritance from parents.
- Lower inflation.
- Higher investment returns.
- Marriage: marriage or remarriage after the divorce or death of a spouse is, of course, a major event that should be a big ladder, because couples typically benefit from joint income and can support each other.

With appropriate retirement planning, retirees can be helped by advisers to prepare in advance to mitigate the impact of many of the shocks. Retirement planning needs to take account of all of a retiree's assets: state pensions and any benefit entitlements, defined benefit (DB) and defined contribution (DC) pensions, nonpension assets, and housing wealth. For those with a number of sources of wealth, holistic retirement planning is essential to optimize income and tax.

RETIREMENT INCOME PRODUCTS

Annuitization¹⁵

Before discussing retirement income products in detail, we need to define annuitization. We use the term annuitization to cover all products that can guarantee a minimum lifetime income however long the retiree might live, and whatever happens to investment returns. Insurance companies can provide this guaranteed lifetime income either by operating a cross-subsidy or by making an explicit charge.

With conventional lifetime annuities, the retiree's capital is put at risk in exchange for a mortality cross-subsidy. This is the transfer of wealth within a pool of annuitants from those who die earlier than their life expectancy—and hence lose their residual capital—to those who live longer: an earlier-than-expected death creates a mortality release that the annuity provider uses to fund income for those who live longer than expected. In effect, the mortality cross-subsidy generates survivor credits that increase with age and that continue as long as the annuitant is alive, thereby ensuring the lifetime income guarantee.

With VAs, extra fund charges are made for the lifetime guarantee and these accumulate the longer the policyholder lives. The result is that those dying early provide only a modest cross-subsidy to those living longest. Those living longest pay the most charges and this is reflected in a lower lifetime income than available under the conventional annuity's cross-subsidy approach, all other things being equal.

¹⁵ In most countries, DB pension wealth is automatically annuitized. The focus in this article is, accordingly, on the optimal use of DC and nonpension wealth.

DC Pension Products

The principal retirement income products available from DC pension plans are:

- Conventional lifetime annuities, such as fixed and index-linked annuities.
- Income drawdown (also known as systematic, programmed, or phased withdrawal): the retiree's assets remain fully invested, but some of the assets are sold each year to pay an income to the retiree (in addition to any income the assets themselves produce).
- Investment-linked annuities—such as with-profit annuities, unit-linked annuities, flexible annuities—and VAs.

Conventional Lifetime Annuities. Conventional lifetime annuities provide a guaranteed income for life, either in nominal or real terms. In their simplest form, there is no death benefit and the income is a fixed monetary amount that includes the survivor credits. As of May 2010, a £100,000 premium will buy a 65-year-old male a fixed annuity for life of £6,840 per annum in the United Kingdom. Guaranteeing that the annuity payments are made for at least 10 years reduces the annual payment by 2 percent to £6,720. A capital-protected annuity reduces the annual payment by 6.4 percent to £6,400.¹⁶ An index-linked annuity starts at £4,300 and will increase in line with increases in the retail price index (RPI).

The purchaser of a conventional lifetime annuity removes two key risks, longevity risk and investment risk. Longevity risk is removed by the insurance company guaranteeing to pay income however long the pensioner lives. The Global Financial Crisis has highlighted the importance of the investment guarantee that insurance companies give to a retiree when they buy an annuity. From an investment perspective, retirees gain in four ways:

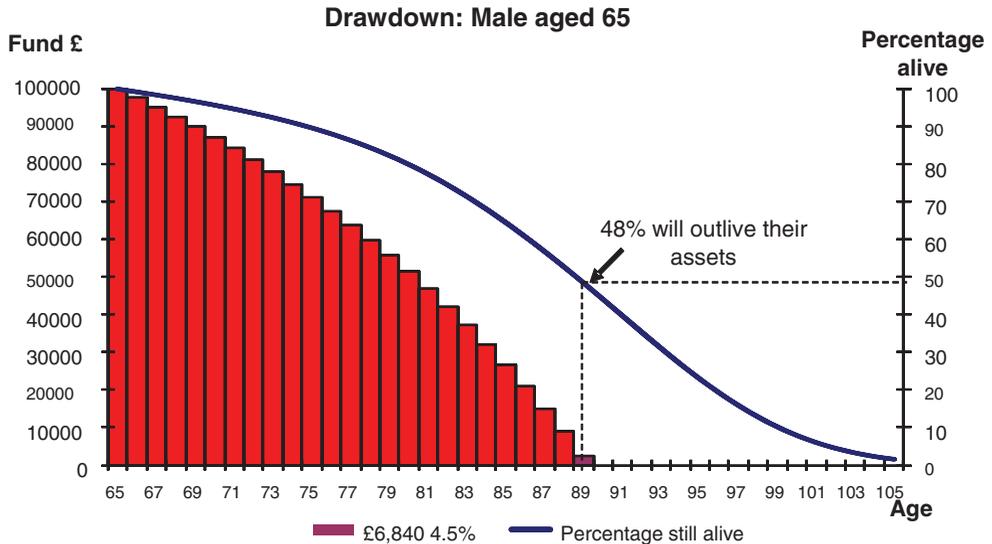
- Because annuitants give up control over their assets, insurance companies can invest in illiquid investments, such as long-dated corporate bonds to match their liabilities. Insurance companies pass on a significant portion of the liquidity premium to retirees, resulting in higher annuity rates.
- Insurance companies are able to manage reinvestment risk within their annuity portfolios much more efficiently than individuals.
- Insurance companies take on credit risk, again typically in the form of corporate bonds, and pass on some of the credit risk premium to annuitants, since they can diversify the credit risk against longevity risk which has low correlation with credit risk.¹⁷
- Annuitants benefit from the ability of insurance companies to pool the funds of annuitants which allows them to invest in fixed-interest or

¹⁶ The reduction in income on a joint-life capital-protected annuity for a couple both aged 65 would be much smaller at around 1 percent.

¹⁷ Longevity risk is not completely uncorrelated with credit risk, since the holders of corporate bonds in companies with deficits in their pension funds arising from increased longevity face an increase in credit risk.

FIGURE 2

Drawdown From Age 65: Income of £6,840 Yearly in Arrears With a 4.5 Percent Fund Growth Rate



Source: Own analysis using 100% PNMA00 2010 plus improvements in line with CMI_2009_M [1.00%].

inflation-linked investments that would not be directly available to individuals. For example, insurance companies can participate in infrastructure projects or large commercial property investments.

Income Drawdown. Figure 2 shows the situation with income drawdown and the same £100,000 premium. Suppose the individual decides to withdraw £6,840 each year and that the investment return on the fund is 4.5 percent after charges.¹⁸ This enables the same income as the annuity to be drawn each year, so long as there are sufficient funds remaining. The bars in Figure 2 show the depletion of the fund, whereas the line shows the percentage of lives expected to still be alive at each age. The fund is exhausted by age 90 and there is a 48 percent chance that the retiree will outlive his assets, may be by many years. The advantage of drawdown, however, is that if the retiree dies before age 90—and over half will—his estate will receive the balance of the fund, whereas with a standard annuity without any death benefit, the estate gets nothing.

Some retirees might believe they can generate higher returns in retirement by investing a greater proportion of their fund in riskier assets, such as equities. When the annual income drawn remains at £6,840, but an investment return of 5.5 percent after charges is generated, the fund would be exhausted by age 96 and some 22 percent of retirees

¹⁸ This rate was chosen as it represents a higher investment return than available under conventional annuities invested in bonds due to a proportion of the fund being invested in equities.

would still outlive their assets. However, equity prices are more volatile than those of bonds. If income is taken when asset prices are depressed, the fund can run down very quickly, particularly when a significant income relative to the fund size is being withdrawn at older ages. The purchasers of income drawdown products retain all risks, particularly longevity and investment risks and, in addition, do not benefit from survivor credits.

Investment-Linked Annuities and VAs. The survivor credits can operate within investment-linked annuities, such as with-profit annuities, unit-linked annuities, and flexible annuities (Wadsworth et al., 2001).

In the case of with-profit annuities, the pension fund is invested in a risk-graded managed fund. The annuity payment is based on an anticipated smoothed investment return. The initial income generally starts at a similar level to the fixed annuity and, if investment performance is good, income increases. However, the annuity payment could be reduced if the assumed smoothed return turns out to be lower than the actual return.

With unit-linked annuities, the capital sum is invested in a unit-linked fund and each year a guaranteed number of units are sold to provide the annuity payment. The initial payment is typically lower than with an equivalent-level annuity. The annuity fluctuates in line with the unit-linked fund's price. Income equal to the value of the units is guaranteed to be paid however long the annuitant lives.

With flexible annuities, the annuity payment can be varied within limits at the annuitant's option. Income is dependent on investment performance; if investment performance is lower than expected, this impacts the level of future income. The pension fund is invested in a risk-graded managed or unit-linked fund. A variation on this is to purchase a sequence of 5-year limited period annuities to provide the income, at each stage retaining sufficient wealth to fund future purchases in the sequence.

VAs can be thought of as drawdown with guarantees, and, as a result of the guarantees, will provide a lower income than a lifetime annuity.¹⁹

Nonpension Products

As highlighted in the "Needs, Risks, and Financial Resources in Retirement" section, mass affluent and high net wealth retirees have considerable nonpension wealth. With nonpension products, there is a wider choice of investments. Options include:

- Cash-based products and guaranteed bonds from banks and insurance companies.
- Life bonds, with-profits bonds, VAs, and mutual funds offering exposure to equities, corporate bonds, and property.
- Insurance companies also offer immediate-needs annuities²⁰ that provide a guaranteed lifetime income.

¹⁹ For more details of the U.K. annuity market, the world's largest, see Wadsworth et al. (2001), Boardman (2006), and Cannon and Tonks (2008).

²⁰ These are annuities purchased when a retiree enters a care home; the annuity payments are made directly to the care home and are paid tax-free.

- Direct property investments ranging from own residence, buy-to-let, and commercial property.
- More specialist investments often with tax incentives and that typically offer a higher anticipated reward in exchange for higher risk.

THE OPTIMAL USE OF PRODUCTS AND THE OPTIMAL INVESTMENT STRATEGY

The Optimal Use of Products

The optimal use of the products discussed in the previous section will depend on the source of the retiree's wealth and the segment of the market to which the retiree belongs.

Retirement expenditure planning is about trade-offs:

- Higher income and expenditure today versus higher income and expenditure later.
- Higher income and expenditure versus higher inheritance.
- Protecting against future inflation versus higher immediate income.
- More investment risk versus more certainty in retirement income.
- Buying longevity insurance versus assuming longevity risk.

Personal circumstances will influence the appropriate decisions for an individual. Nevertheless, these trade-offs are hard even for professional financial planners, economists, and actuaries to make, let alone members of the general public. Most people typically have limited planning skills, a very limited understanding of inflation, investment, and longevity risks, and find it difficult to make choices that impact outcomes some time into the future. Planning retirement finances in the context of the level of uncertainty surrounding the length of life depicted in Figure 1 is difficult and shows the importance of a guaranteed lifetime income.

In general terms, successful retirement expenditure planning can be defined as ensuring a dependable posttax income stream for life to meet expected needs, with insurance strategies to cover the key risks that could significantly upset the plan together with a "rainy day" fund to provide the flexibility for when insurance is either unavailable or uneconomic. It is important to ensure that first "essential" and then "adequate" income levels are as secure as possible. Adequate income is an income that better reflects a retiree's needs taking account of past living standards. Some flexibility can be retained initially around how and when income between an "essential" level and an "adequate" level is secured. The closer the cost of securing "adequate" income is to total wealth, the more important it is to use annuitization products as soon as possible. Much more flexibility can apply to wealth beyond the "adequate" level, as "desirable" spending tends to be more *ad hoc* (e.g., a world cruise) and is likely to compete with the wish to make bequests.

Planning and associated budgeting become particularly important in retirement on account of the difficulty, if not impossibility, of returning to employment in order to generate additional income. The first task in retirement is therefore to make a plan starting by comparing projected essential expenditures against projected total after-tax income, including any DB pension, state pensions, and means-tested benefits, making

allowance for any inflationary uprating. If there is an expenditure deficit, the retiree needs to consider how the gap can be filled; this may require a reassessment of adequate and essential expenditure. If there is an expenditure surplus—current as well as projected in future years—the retiree can plan for some desirable expenditures. The retiree also needs to assess potential risks and changes to both projected essential expenditures and projected posttax income arising from, say, tax changes or changes in circumstances (as discussed above).

Turning to the different market segments, we begin with the low affluent and the mass market. Low affluent retirees have very little savings, pension, or housing wealth and therefore will be very reliant on state support throughout their retirement. Most mass market retirees also have limited means. Since state pensions and benefits are the dominant source of retirement income for the majority of these retirees, mass market households are likely to have to accept a relatively simple strategy. Their primary focus will be on achieving the optimal balance between the size of their “rainy day” fund and their level of guaranteed retirement income, taking into account any implications of the size of the “rainy day” fund on their entitlement to means-tested state benefits. A conventional annuity-based solution is probably going to be the best option for most of the mass market. In practice, the mass market will rely heavily on the state and any housing equity will be used to provide for health care and other retirement contingencies. Bequests, mainly in the form of residual housing equity, will be typically left more by chance than design.

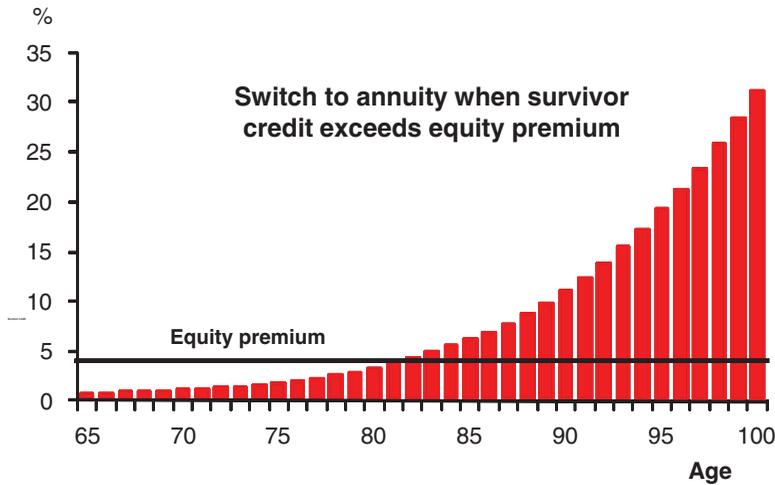
The position of the 20 percent minority fortunate enough to be in the mass affluent and high net worth segments is different. For these retirees, retirement income and expenditure planning needs to be looked at holistically.

The first point to recognize is that it is a very complex task to optimize the controlled rundown of a retiree’s assets throughout their retirement, especially in the early years of retirement. Optimization is particularly difficult for retirees in their 60s who are looking forward to a retirement of 20 years or more. The investment strategy needs to be far more sophisticated in decumulation than in accumulation. This is because of the lack of certainty around the duration of the payments and the difficulty of recovering from adverse investment conditions if, at the same time, the retiree needs to sell assets to provide income. Unlike mass market retirees who can rely on the majority of their income being inflation protected by the state, the mass affluent need to take account of and manage their inflation risk. Given the considerable doubt and uncertainty in the early years of retirement, it generally makes sense for retirees to be as flexible as possible and retain control over their assets if they can afford to do so.

Mass affluent pensioners should take early steps to top up their essential income and secure an adequate base income using an index-linked annuity. They should also look to use insurance, if available and cost effective, to reduce the uncertainty from adverse events. Housing equity has a key role in any optimization strategy: it could provide a source of additional income utilizing equity release. In addition, housing equity allows greater investment risk to be taken and it will often be the main funding source for any bequests.

Fortunately, as people get older or, more strictly, as their remaining life expectancy decreases, the optimization task becomes simpler. When life expectancy is less than

FIGURE 3
The Milevsky Switching Rule



Source: 100% PNMA00 2010 plus improvements in line with CMI_2009_M [1.00%]; Survivor credit = $q_x / (1 - q_x)$.

5 years, investment considerations become easier as bonds or annuities and cash become the optimal core holding. Also if and when people go into a nursing home, income expenditure becomes less volatile and more predictable. Overall, there is a narrowing funnel of uncertainty based on life expectancy.

The Optimal Investment Strategy Including Optimal Age to Annuitize

The optimal investment and longevity strategy is complex and impossible to implement without sophisticated stochastic dynamic programming software. Milevsky (1998) proposed a simple rule of thumb for deciding when to switch from risky equity-linked assets to an annuity: this is when the survivor credit resulting from the mortality cross-subsidy exceeds the equity premium as shown in Figure 3. The survivor credit for a particular age (x) can be thought of as the excess return on a level annuity over a risk-free investment: it is equal to the ratio of the proportion of the annuitants aged x who die during a particular year (having survived to the beginning of that year) to the proportion of the annuitants aged x who survive the particular year. The equity premium is the excess return of equities over a similar risk-free investment.

In the early years after retirement, the equity premium exceeds the survivor credit and, all other things being as expected, the retiree receives a higher average return from investing in an equity-dominated portfolio than investing in a fixed annuity. However, the level of the survivor credits increases each year and eventually exceeds the equity premium. Figure 3 shows that the switchover age is around 80 if the equity premium is 4 percent.

This approach has been a popular rule of thumb used by advisers to determine when retirees should annuitize. However, Wadsworth et al. (2001) argue that

investment-linked annuities fully hedge longevity risk, while also benefiting from both survivor credits and higher average returns than fixed annuities. Boardman (2006) shows that death benefits can be built into the annuity. In simple terms, all contracts trade off death benefits against higher income. Ultimately, optimization comes down to what risk of a reduction in future lifetime income a retiree is prepared to accept for retaining control over their assets.

If a retiree decides not to annuitize his retirement pot at the beginning of a year, then, all things being equal, he will secure a lower income if he annuitizes at the end of the year.²¹ As Figure 3 shows, the survivor credits also increase exponentially as age increases, thereby, from a longevity risk perspective, making annuitization essential for anyone without extensive wealth.

In the early years of retirement, it is investment risk, rather than longevity risk, that is likely to be more significant. The loss of survivor credits in the early years can result in a reduced income of a few percent, but investment risk can have a much bigger impact. If annuitization is delayed a year, then the fund can suffer significant investment losses, particularly if a large proportion of the fund is held in equities. There could be some mitigation if the interest rates used in calculating annuity prices increase to reflect a fall in equity values,²² but the impact can still be very significant. Of course, if mean reversion holds, the retiree could delay annuitizing and wait for equity values to recover. However, if the retiree needs to continue to withdraw income when investment values are depressed, the fund can run down rapidly. Depending on the scale of other wealth, the retiree might not be able to delay annuitization and hence might be forced to buy an annuity with the proceeds from a depleted pension fund. As the retiree gets older, the impact of any investment losses also grows in importance, because the percentage of the fund that needs to be withdrawn each year to maintain the desired income increases as the fund is run down.

For the vast majority, it is not a question of if, but when they should annuitize. The key questions are: what is the optimal asset allocation and when should assets be annuitized? Increasingly sophisticated stochastic dynamic programming models are being developed to attempt to answer these questions.

The optimal investment strategy will be the one that maximizes the retiree's expected utility or welfare of expenditure over their expected remaining lifetime (Merton, 1971; Blake et al., 2003). This requires knowledge of the size of the retiree's relative risk aversion

²¹ This occurs because if a retiree aged x (with life expectancy e_x) lives to the end of the year, his life expectancy at age $x+1$ (e_{x+1}) will be greater than his life expectancy at the beginning of the year minus the year he has survived (i.e., $e_{x+1} > e_x - 1$). An approximation for the reduced income that the retiree will be able to secure at the year end is $(e_x - 1) / e_{x+1}$. This yearly reduction factor decreases as x increases, so the impact of not annuitizing grows exponentially as the retiree ages. The actual loss from a longevity risk perspective will be higher or lower depending on any changes that are made during the year to longevity assumptions around current levels and future improvements.

²² Yields on long-dated bonds tend to be negatively correlated with equity values.

TABLE 1

The Optimal Weight in Equities and Optimal Age to Annuitize With No Bequest Requirement

Relative Risk Aversion	Optimal Weight in Equities	Optimal Age to Annuitize
Very low: Below 1.43	Extreme: 100%	Between 73 and 79*
Low: 1.43–2.25	High: 75%	Between 70 and 72*
Moderate: 2.26–3.56	Moderate: 50%	Between 66 and 69*
High/extreme: Above 3.56	None: Annuities only	Immediately at retirement age of 65

*Depending on fund performance—poor fund performance will trigger earlier annuitization.
Source: Blake et al. (2003, Tables 5 and 6).

(RRA)²³ and bequest intensity²⁴ parameters. These influence both the optimal weighting of risk assets (principally equities) in the postretirement investment portfolio and the optimal age to annuitize.

Table 1 shows typical ranges for four broad categories of risk aversion and the corresponding optimal weight in equities and optimal age to annuitize for a U.K. male when there is no desire to leave a bequest, according to a study by Blake et al. (2003) that used stochastic dynamic programming to work out the optimal strategy over time under the assumption that the only assets are pension assets. When risk aversion is low, a high equity exposure is optimal, and can even go as high as 100 percent in the case where risk aversion is very low (i.e., close to being risk neutral). On the other hand, when risk aversion is extreme, the optimal strategy is to purchase annuities and have no equity exposure at all.

In terms of deciding the best age to annuitize, the optimal dynamic strategy operates as follows. At the beginning of each year, the retiree decides to annuitize immediately, or wait one more year, taking into account the expected return on the fund, the probability of surviving the year, and the value, if any, attached to a bequest (of the remaining fund) if the retiree happened to die during the year (Blake et al., 2003, Section 4.6). If investments are performing well, it is more likely that annuitization will be delayed.²⁵ However, if the fund size is small, say as a result of very poor performance over the preceding year, this is likely to bring forward the annuitization decision, because the bequest value of the fund is small and the retiree can start to enjoy the maximum possible secured lifetime income by electing to receive survivor credits.

²³ RRA determines the size of the risk premium that an investor would be willing to pay (as a percentage of wealth) to avoid risk or volatility, where the risk premium = $RRA \times \text{volatility}$ and *volatility* measures the standard deviation of the return on wealth (Pratt, 1964). Increasing RRA increases the risk premium and also implies that the percentage of wealth willingly exposed to risk decreases with the level of wealth. Blake (1996) reports studies that indicate that RRA can differ widely across individuals, ranging between 1 and 48.

²⁴ This quantifies the desire to make a bequest.

²⁵ In other words, the optimal annuitization age is path dependent (i.e., dependent on the size of the fund and the realized return on the fund).

TABLE 2

The Optimal Weight in Equities and Optimal Age to Annuitize With a Bequest Requirement

Relative Risk Aversion	Optimal Weight in Equities	Optimal Age to Annuitize
Very low: Below 1.43	Extreme: 100%	Between 75 and 80*
Low: 1.43–2.25	High: 75%	Between 71 and 74*
Moderate: 2.26–3.56	Moderate: 50%	Between 68 and 71*
High: 3.57–4.50	Low: 25%	Between 66 and 67*
Extreme: Above 4.50	None: Annuities only	Immediately at retirement age of 65

*Depending on fund performance—poor fund performance will trigger earlier retirement.
Source: Blake et al. (2003, tables 5 and 6).

When risk aversion is very low, it does not become optimal to annuitize until some age between 73 and 79, with the precise age depending on the individual's actual RRA; at this age, it becomes optimal to annuitize all remaining assets. For those who are extremely risk averse, it is optimal to annuitize immediately on retirement. For those with low or moderate risk aversion, it is optimal to annuitize some time between the ages of 66 and 72, depending on fund performance. Larger fund sizes will delay the optimal age to annuitize.²⁶

At each level of risk aversion, any value attached to the bequest delays annuitization. It also increases the optimal equity weighting if the degree of risk aversion is already high, but has no effect on the optimal equity weighting if the degree of risk aversion is moderate or low. These findings are shown in Table 2.

The bequest motive considered above focused on ensuring capital in pension funds is not lost prematurely. However, it is important to recognize that both pension and purchased life annuities can be useful to the high net worth segment to secure the bequests they wish to make. By annuitizing sufficient wealth to live comfortably in old age, the wealthy can ring fence assets that they wish their children to inherit. In this sense, annuities are valuable in reducing the variability in the amount of wealth to be inherited as well as the timing. With sufficient annuitization and long-term care insurance in place, wealthy people can choose when the desired bequest takes place and can minimize the tax consequences.²⁷

The Optimal Level of Annuitization

Although a lifetime annuity hedges longevity risk, there are some rational reasons for not fully annuitizing retirement wealth with a conventional-level annuity, the type that most

²⁶ The model in Blake et al. (2003) did not allow for longevity improvements. When longevity improvements are allowed for, the optimal age to annuitize will increase over time. An alternative to annuitizing when an individual reaches a certain age is to annuitize when an individual's life expectancy falls below a certain level.

²⁷ The analysis above was based on a single male life. It is optimal for females and couples to annuitize later than males.

people buy and the only type that might be available in certain countries. A conventional level annuity does not:

- Have the flexibility to change the pattern of income payments made in response to a change in circumstances after the annuity has been purchased.
- Allow for bequests other than through limited death benefit options (Dynan et al., 2002; Davidoff et al., 2005).
- Hedge postretirement inflation.
- Allow for postretirement investment opportunities and differing attitudes to risk.
- Allow for poor health at retirement or long-term care costs.

Now in developed annuity markets, such as the United Kingdom, annuities have been introduced to deal with some of these issues. For example, it is possible to purchase a value-protected annuity, an index-linked annuity, an investment-linked annuity, and an impaired life annuity. Indeed, those with impaired lives, such as individuals with cancer, get higher guaranteed income levels to reflect this, so the selection effect is minimized.²⁸

Although the design of annuities has improved, they still lack flexibility once purchased and this is an important weakness, given the length of time people live after retirement. A lifetime annuity does not allow for precautionary expenditures, such as major repairs to home or car or lumpy medical expenses. Credit markets are imperfect and it is difficult, if not impossible, to borrow against future annuity payments, since they cannot be legally assigned (so no loan contract could be legally enforced). As a result, individuals tend to retain large holdings of nonannuitized assets until very late in life to allow for such expenses (Sinclair and Smetters, 2004; Turra and Mitchell, 2004; De Nardi et al., 2006).

It is also important to examine other income sources in retirement and consider how these might rationally influence the demand for annuities. For individuals who have significant DB pensions and other sources of disposable wealth, being able to invest the fund directly, rather than annuitize, might be a more rational option. Risk sharing within the family reduces the demand for joint-life annuities (Kotlikoff and Spivak, 1981; Brown and Poterba, 2000). Finally, annuities might be poor value due to adverse selection and cost loadings (Friedman and Warshawsky, 1990). The money's worth of an annuity typically lies in the range 90–94 percent in competitive annuity markets and these cost loadings are not large enough to offset the welfare gains from annuitization (Mitchell et al., 1999). In particular, the scale of the market in the United Kingdom has allowed individual life expectancies to be taken into account, with the result that annuities have become much fairer.

²⁸ Selection effects arise when nontypical individuals—with either much higher or much lower life expectancies than average—choose or select to buy annuities and receive a return that is actuarially unfair—either too high or too low—compared to the average annuitant. If the return offered to these individuals is too high, this can reduce the annuity provider's profit. If the return offered to these individuals is too low, this reduces the value of the annuity they receive, that is, its money's worth.

“All-or-nothing” annuitization is likely to be suboptimal (Milevsky and Young, 2002; Horneff et al., 2008). The phased purchase of annuities over time might be a better option, since it deals with interest rate risk (by helping to hedge the interest rate cycle),²⁹ the possibility that investment returns might be higher in the phasing-in period, and the possibility, however unlikely, that expected mortality rates might be higher in future.

Summary

To sum up, the key issues relating to the optimal timing and level of annuitization of DC pension wealth are:

- The value to securing the survivor credit that will be a function of remaining life expectancy and marital status.
- The value of locking into a guaranteed lifetime income that will be a function of wealth including entitlement to state and DB pensions, required income level and expectations concerning future inflation.
- Attitude to risk.
- The value attached both to bequests and to their timing.
- The money’s worth of the annuity and hence the fairness of annuity pricing, taking account of the retiree’s health and life expectancy. If the money’s worth of available annuities is very poor, it might be rational not to annuitize, despite the loss of longevity risk protection.

WHY DO PEOPLE NOT BEHAVE OPTIMALLY?

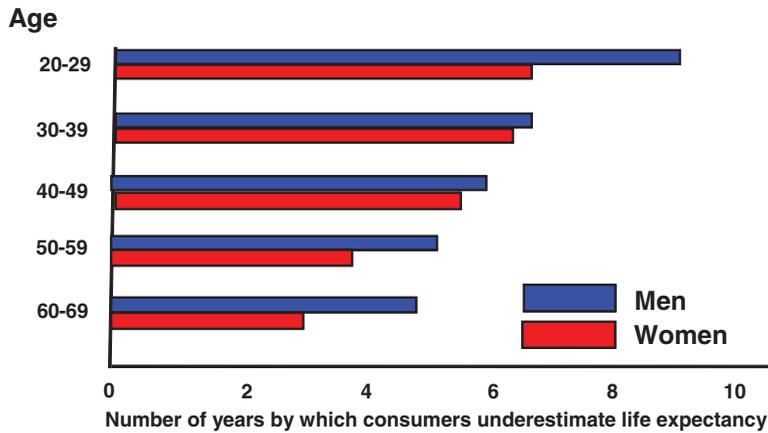
In the previous section, we discussed what people would do if they were behaving optimally in retirement. But there is a lot of evidence to indicate that people do not behave optimally. For example, retirees do not annuitize sufficiently, at least according to economic theory (Yaari, 1965; Davidoff et al., 2005). Yet, as we have seen, conventional lifetime annuities provide the maximum lifetime income, for a given amount of capital, to protect retirees from outliving their resources however long they remain alive.³⁰ Economists call this reluctance to annuitize the “annuity puzzle.” Even individuals with shorter expected lifetimes, such as the low paid, would benefit from annuitization (Brown, 2003).

A related issue is that, again according to economic theory, retirees do not dissave sufficiently during retirement. In the United States, only 30 percent of assets are “life-cycle assets,” intended for decumulation during the current working generation’s lifetime; the rest were inherited (Kotlikoff and Summers, 1981). It is hard to believe that previous generations of U.S. citizens planned to bequest so much of their wealth to future

²⁹ Blake et al. (2003) examine the age at which it becomes optimal to annuitize fully. There is no interest risk in their model, so phased annuitization to hedge interest rate risk is never an optimal strategy in their model.

³⁰ As discussed in the “Retirement Income Products” section, variable annuities also provide a guaranteed income for life, but this is achieved through charges, so the guaranteed income is considerably lower than with a conventional annuity.

FIGURE 4
Individual Underestimates of Life Expectancy by Age



Source: O'Brien et al. (2005), self-estimated life expectancy compared to GAD forecast life expectancy; own analysis.

generations: it is much more likely that these bequests were unintentional with retirees' spending too little for fear of running out of money.

In the previous section, we put forward some powerful rational reasons for not annuitizing all wealth, for example, it is optimal to retain flexibility if contingent spikes in expenditures cannot be insured against or can only be insured at excessive cost. However, there are a whole range of behavioral reasons why retirees do not annuitize a sufficient proportion of their retirement wealth:

- Inertia and procrastination: people have to make the active decision to start a retirement expenditure plan or purchase an annuity (Madrian and Shea, 2001).
- Poor financial literacy: many, if not most, people do not recognize the importance of securing a basic understanding of retirement income provision and planning and, as a consequence, are not sufficiently competent to manage the conversion of their investments to income in old age (Dus et al., 2004) or are unwilling to make the effort to understand unfamiliar products (Hu and Scott, 2007).
- This is compounded by poor estimates of life expectancy and poor understanding of the variability of actual lifetimes: in short, a poor understanding of the nature of longevity risk. Figure 4 shows the results of a study by O'Brien et al. (2005) of how people in different age groups in the United Kingdom underestimate how long they will live compared to how long the U.K. Government Actuary's Department (GAD) expects them to live. Most men in their 60s underestimate their life expectancy by around 5 years at retirement, whereas for women it is around 3 years. Even more important, individuals find it difficult to appreciate the variability around expectation of life (Figure 1). Similar results hold in the United States (Drinkwater and Sonderegeld, 2004).

- Aversion to dealing with complex problems involving a sequence of choices.
- Related to this is the issue of choice overload—having so many choices that you end up making no choice at all (Iyengar and Kamenica, 2010).
- Aversion to planning—particularly in respect of large infrequent transactions.
- Related to this is aversion to paying for advice.
- Illusion of control: people like to feel in control of their capital, but annuitization leads to a “loss of control.”
- Unwillingness to contemplate unpleasant events, for example, dying and leaving behind dependants.
- Overconfidence: many people underestimate how much they need to live on after retirement (Mitchell and Utkus, 2004b).³¹
- Related to this is lack of self-control: some people actually spend all their retirement savings within a few years of retirement (Mitchell and Utkus, 2004b).
- Hyperbolic discounting: this leads to a poor understanding of the distant future and a poor understanding of the effects of inflation in reducing purchasing power over time (Laibson, 1997; Warner and Pleeter, 2001).
- Mental accounting: individuals tend to assign assets to different mental accounts such as “assets available for current expenditure” and “assets available for future expenditure.” The assets in the different accounts are treated as nonfungible, which implies that individuals are likely to have different marginal propensities to consume out of the assets in the different mental accounts. All this is inconsistent with the LCM, which treats all assets holistically and hence leads to a single marginal propensity to consume from total wealth, the one that maximizes total lifetime expected utility. In terms of the decumulation of pension assets, the pension pot at retirement is likely to be assigned by individuals using mental accounting to the first of the above mental accounts if it can be taken as a lump sum and to the second if it has to be taken as an annuity. Since the marginal propensity to consume out of the first mental account is likely to be higher than out of the second, individuals who employ mental accounting are likely to value the annuity less than they value the lump sum (Thaler, 1985; Shefrin and Thaler, 1988; Choi et al., 2009).
- Framing effects: retirees can be unduly influenced by the way things are communicated to them. For example, choices can be framed in a way that causes people to overvalue the “large” lump sum in their pension fund at retirement and undervalue the “small” annuity. Similarly, when annuities are discussed using a “consumption

³¹ Overconfidence is very common in human decision making. It is particularly common in investment decision making by both retail investors (Odean, 1999; Grinblatt and Keloharju, 2009) and institutional investors (Barber and Odean, 2001; Ekholm and Pasternack, 2008; Bar et al., 2011; Puetz and Ruenzi, 2011). Overconfidence can be explained by a self-attribution bias, whereby individuals update their beliefs about their own ability as being attributable to skill following good outcomes, but due to bad luck after bad outcomes. They become more overconfident after good past performance, but not less confident after bad past performance (Gervais and Odean, 2001).

frame,” their value can be appreciated, but when they are discussed using an “investment frame,” they appear to be risky.

- Negative norming of annuities: annuities have a bad press in most countries. Commentators typically convey a negative impression about annuities and frequently talk about annuities being “legalized theft” rather than the “smart” thing to buy.³² It is interesting to contrast this with the positive view of DB pension schemes that effectively enroll all pensioners into an annuity!
- Related to framing and negative norming is herding or peer effects: if dominant members of a peer group, such as employees near retirement at a company, trash annuities, then this could lead to a herd effect whereby no members of the group choose to buy annuities (Raafat et al., 2009).
- Loss aversion rather than risk aversion: many individuals wish to avoid making losses and seek to avoid putting themselves into a position where losses might occur, even if this means foregoing large gains with a high probability. Kahneman and Tversky (1979) and Tversky and Kahneman (1991, 1992) name the theory underlying this behavior (cumulative) prospect theory. Such behavior is inconsistent with the LCM, which assumes that risk aversion influences but does not impede risk-taking behavior and which recognizes that losses are an occasional and unavoidable consequence of the risk taking that is needed to maximize expected utility. A common view is that “*annuities are a gamble.*” The probability of dying very soon after purchasing an annuity is very low, but this probability is likely to be overestimated, so the “loss” is perceived to be high: “*what dying and losing all my capital too!*” Conversely, the significant probability of outliving one’s resources if one does not annuitize is underestimated, so the “gain” is perceived to be low. Hence the “gain” from annuitizing will give only a small utility benefit, whereas the “loss” from dying early might have a large utility loss. Loss aversion is not by itself a sign of irrational behavior. However, the tendency to overestimate the probability of low-probability events and underestimate the probability of high-probability events is certainly irrational.
- Finally, there is regret or disappointment aversion: individuals might choose to avoid making a decision because they might regret or be disappointed by the consequences of that decision. Again the decision not to buy an annuity might be the result of this type of aversion (Huang and Su, 2010).³³

³² Here is a typical example reported on BBC News on July 31, 2001: “Asker Jetha believes annuities are a form of ‘legalized theft.’ He had been looking after his mother’s financial affairs for years, and had advised her to get a personal pension. Asker read a newspaper article which made him realize she would be forced to buy an annuity, and when she did, the capital sum from her pensions savings would be lost to the family on her death” (news.bbc.co.uk/1/hi/business/1466333.stm).

³³ Loss aversion differs in a subtle way from regret aversion. With loss aversion, individuals are risk seeking in the domain of losses and risk averse in the domain of gains relative to an *exogenous* reference point. Regret aversion implies individuals anticipate *ex ante* the regret they will feel *ex post* if they made a suboptimal decision; in this case, the reference point is the best decision that could have been made and the reference point is *endogenous* in the decision process.

NUDGING AND CHOICE ARCHITECTURE

In the previous two sections, we considered the optimal use of annuitization and the behavioral reasons why the level of annuitization in retirement is lower than optimal. We also provided some rational reasons for not annuitizing or more commonly delaying annuitization.

Improvements in the design of annuities—particularly those related to capital protection and improving the money’s worth of annuities for those with impaired lives—have gone some way to removing the rational reasons for inadequate annuitization, although the issue of inflexibility once an annuity has been purchased remains. However, these improvements have not dealt with the behavioral barriers to higher annuitization. Yet, it remains the case that only lifetime annuities can mitigate poor estimates of life expectancy, poor understanding of longevity risk, and some of the behavioral biases outlined in the previous section. In fact, we can think of annuities as a perfect bond maturing precisely when the individual (or couple) dies. Nevertheless, we should not underestimate the barriers involved in getting people to the optimal level and timing of annuitization.

In this section, we return again to Thaler and Sunstein’s (2008) distinction between “econs” and “humans” and accept that most people belong to the latter group. We should therefore recognize that the retirement stage of a pension plan is just too complex for most people to deal with without any outside intervention. This implies that we need to consider how nudging and the use of a choice architecture in decision making—ideally also combined with advice—can be used to help “humans” make optimal solutions for themselves. This is where a SPEEDOMETER retirement expenditure plan comes in.

We need to recognize that retirees: have different expenditure needs during different phases of their retirement, need to pace their spending throughout retirement in order to optimize the use of their lifetime assets and income and their ability to make intended bequests, and need a choice architecture that reflects the market segment to which they belong.

Bearing all these considerations in mind, a SPEEDOMETER plan has the following components:

1. **First, make a plan.** This can be done, either by being auto-enrolled into one as part of the retirement planning service offered by the plan member’s company, or by an online or telephone-based service providing generic financial advice, or, if wealth permits, involving a financial adviser whose role is to assist with making and implementing the plan and conducting annual reviews. The remaining components implement the plan. Ideally, planning should occur throughout the accumulation phase. It is very important as retirees approach retirement for planning to take place to determine the optimal time for annuitizing as this can determine the optimal life-cycle strategy including a precommitment to automatically phase into annuities.³⁴

³⁴ Planning needs to capture sufficient information about the retiree (date of birth of spouse, health of retiree and spouse, etc.) to establish the default arrangements at retirement.

2. **Second, secure “essential” income.** The plan needs to take a holistic approach to managing *all* assets and income sources in retirement and not just pension assets and income, with the aim of securing, as a very *minimum*, a core inflation-protected income sufficient to allow the retiree to meet “essential” needs for the remainder of their life. The default annuity will be a “money-back” index-linked lifetime annuity with the option to opt for an alternative choice.³⁵
3. **Third, have insurance and a “rainy day” fund to cover contingencies.** The plan uses insurance, when available and cost effective, to cover contingency events, such as repairs to white goods, central heating, and car. Some expenditures in retirement will be lumpy (e.g., holidays and car purchase), so it is important to have a “rainy day” fund of liquid assets in order to retain as much flexibility as possible with retirement assets. The lower the level of insurance used, the higher the “rainy day” fund needs to be. Care costs are potentially the greatest spike to expenditure. There is currently a limited insurance market for care costs other than immediate-needs annuities that can be purchased when retirees enter care homes. This lack of prefunded long-term care insurance requires the mass affluent to retain a considerable fund against this possibility. For those with limited means, the state will provide care and this illustrates the need for retirees to be aware of how they can maximize means-tested benefits to their advantage.
4. **Fourth, secure “adequate” income.** Many people will, of course, wish to secure a higher standard of living in retirement than the essential level if they have sufficient resources to meet their needs and wishes throughout retirement, including desired bequests. Implementation will involve the annuitization of (at least some of) these assets as a default option to reach an “adequate” level of income. However, the nature of the default annuity will depend on the market segment to which the retiree belongs. For the mass affluent and high net worth segments of the market, the plan involves automatic, phased annuitization into “money-back,” inflation-linked, fixed, investment-linked, or VAs (depending on the degree of risk aversion and level of wealth of the plan member).³⁶
5. **Fifth, achieve a “desired” standard of living and make bequests.** The plan offers a simplified choice architecture for managing any residual wealth with the aim of achieving a “desired” standard of living in retirement, while allowing part of the remaining wealth to be bequested at a time of the retiree’s choosing. The plan would involve the following:
 - A choice of balanced or diversified growth funds offering a limited range of equity weightings: Blake et al. (2003) show that a choice of just four different equity weightings, 25, 50, 75, and 100 percent is adequate for most members.

³⁵ This recommendation implicitly assumes that the value for money of index-linked annuities is sufficiently high to justify the recommendation. However, a shortage of index-linked bonds to back the annuity payments might mean that index-linked annuities have a lower money’s worth than level annuities.

³⁶ See Gale et al. (2008) for particular application of this.

- Possible additional annuitization (e.g., into a voluntary life annuity or an immediate-needs annuity to cover long-term care costs) to reduce the variability around the level and timing of any desired inheritance.
- Psychological barriers, due to loss aversion, to buying long-term care insurance might be partially overcome through bundling the insurance with an annuity, as suggested by Murtaugh et al. (2001).

We believe that the only way that a *SPEEDOMETER* plan will work for mass market employees is if they are automatically enrolled into one during a preretirement advice surgery ideally arranged through their employer, their pension provider, or an online or telephone-based service providing generic financial advice. Ideally, there needs to be a coordinated approach to education and the selection of life-cycle default accumulation and decumulation strategies. This is necessary to overcome inertia and procrastination, the two key behavioral barriers to decision making. Similar strategies can be used to get them to start the plan as was used to get employees to start a *SMART* plan, for example, sign up now for a plan that starts on the retirement date in 6 months' time, with the option to drop out at any time beforehand.

For the mass affluent and high net worth segments of the market, the first key nudge of the plan is to get preretirees to talk to an independent financial adviser. The extent and timing of the annuitization will depend on the initial assessment by the adviser and the subsequent realized investment performance. Couples will need more flexibility than singles. High net worth retirees will need more flexibility than the mass affluent. The plan also involves annual reviews with the adviser covering: needs (including medical and care needs), state benefits, drawdown strategies for nonpension assets (such as housing equity release), inheritance, and tax. A key task of the adviser is to assess the initial attitude to risk of the member³⁷ in order to determine the appropriate investment strategy for assets that have not been annuitized and to consider whether this has changed in the annual reviews of the plan. It is also important to take actual investment and health experience into account at each annual review. Similarly, it is important to recognize that attitudes themselves can be flexible. The attitudes of parents and children tend to change as they age. Consider the difference in attitudes between 65-year-old parents with 45-year-old children and 85-year-old parents with 65-year-old children: if nothing else, grandchildren come into the picture. Attitudes to annuitization will also change. Once a retiree has held an annuity for some time, they can appreciate better the value of annuitization and be less averse to further annuity purchases.³⁸

Having secured an income for life using lifetime annuities, having insured against lumpy contingencies, and having retained sufficient liquid assets to cover uninsurable contingencies, retirees can be confident that they can spend up to the full value of the annuity payment each period because they will never run out of money however long they live and they will never need to draw on their inheritance assets either.

A *SPEEDOMETER* plan deals with the behavioral traits listed in the previous section:

³⁷ Byrne and Blake (2006) develop a risk profile questionnaire for this purpose.

³⁸ Studies show that people with annuities are happier: they can spend their annuity payments in full each period knowing they have full longevity risk protection (e.g., Panis, 2004).

- Critically, the plan utilizes inertia and procrastination, since, once auto-enrolled, individuals do not tend to change their minds: annuities are, after all, for life!
- Equally important, the plan uses defaults for the mass market (especially into index-linked annuities) and advice as the key nudge for the mass affluent.
- The plan deals with the complexity of decumulation decision making *not* the member, via simple default choices depending on risk aversion, thereby avoiding choice overload and choice sequencing problems, as well as bypassing the problems of poor financial literacy, planning aversion, a poor understanding of longevity risk and the unwillingness of retirees to recognize their own mortality.
- The plan accepts individuals suffer from overconfidence and have self-control and hyperbolic discounting problems and would benefit from using commitment devices.
- The use of “money-back” annuities deals with the aversion to losing control of and the fear of loss of capital on early death. “Money-back” annuities have the following advantages:
 - They remove the single biggest consumer objection to annuities: *“If I die soon after I retire, the annuity provider will keep my fund.”*
 - The “live or die” guarantee of getting your money back provides a simple underpin.
 - They are very easy to explain and for consumers to understand.
 - A lump-sum repayment rather than the continuation of current income for a guaranteed period of 5 or 10 years is easier for people to understand and due to hyperbolic discounting is more valued.
 - The cost of the guarantee is transparent and allows consumers to make an informed choice.
 - They automatically phase pension funds into full annuitization.
 - They remove a significant barrier to preretirement saving: people will not save voluntarily if they do not believe that it pays to save.
- The phasing of annuitization deals with the aversion to making large transactions and possible regret about getting the timing wrong.
- Except for plan members who reveal themselves to be extremely risk averse, the annuity will not be the most prominent feature of the plan for the mass affluent in their early years of retirement. For most mass affluent plan members, what will be discussed first will be the management of retirement assets in accordance with the member’s attitude to risk. Annuities will merely be one component of the management of retirement assets. This helps to overcome framing effects.
- Having dealt with design, effective communication is an equally important feature of SPEEDOMETER plans. It is vitally important that all retirees come to believe that “buying an annuity is a smart thing to do” and buying an annuity remains the norm. It should be a norm that retirees feel very comfortable with because they understand that by annuitizing their wealth, they can “spend more today safely.”

For SPEEDOMETER plans to be effective, they need to comprise a small set of well-designed default options with the flexibility either to change the default if the adviser

identifies the need to do so after the initial discussion with the plan member or to move to a new default option if circumstances change.³⁹ We give some examples of the kind of flexibility we envisage:

- The default is an index-linked annuity, but it is possible to spend more today safely even if the plan member buys a level annuity, because they wish to enjoy higher real income at the beginning of their retirement. Nevertheless, we do not recommend this, as it leaves the annuitant exposed to inflation risk.
- For those with sufficient wealth, their needs could be provided from VAs or other insurance products that provide a guaranteed base income, rather than lifetime annuities.
- Where appropriate, nonpension assets should be annuitized as well. Drawing the maximum income may still be compatible with optimizing inheritance plans (depending on tax rules), but definitely fits in with the concept that SPEEDOMETER plans maximize both flexibility and money to spend.
- Annuitization is valid in joint-life cases, but the optimal timing of annuitization is later and a higher risk investment strategy might also be appropriate.
- The optimal size of the “rainy day” fund will change as circumstances change. For example, when a retiree goes into a care home, contingent expenditures are likely to be significantly reduced.

CONCLUSIONS

SPEEDOMETER retirement expenditure plans provide a holistic approach to dealing with needs, risks, and available financial resources in retirement.

At their simplest, SPEEDOMETER plans involve just four key behavioral nudges:

- First, make a plan—ideally by being auto-enrolled into one or with the help of a financial adviser.
- Automatic phasing of annuitization (i.e., gradual auto-enrollment): this is designed to tackle the aversion to large irreversible transactions and losing control of assets and so allow the greatest possible degree of flexibility in managing the rundown of retirement assets.
- Capital protection in the form of “money-back” annuities: this deals with loss aversion, that is, the fear of losing your money if you die early.
- The slogan “spend more today safely” that utilizes hyperbolic discounting to satisfy the human trait of wanting jam today and to reinforce the idea that “buying an annuity is a smart thing to do.”

SPEEDOMETER plans are designed for both “econs” and “humans,” but a libertarian paternalistic approach (along the lines of Thaler and Sunstein, 2003) needs to be adopted

³⁹ However, it is important to note that this flexibility is available prior to annuitization, but not after.

to encourage “humans” to implement them. They involve a strong nudge to encourage “humans” to begin the plan and annuitization as a default strategy at some stage in the plan member’s (and possibly their partner’s) life. This is because longevity risk is significant and poorly understood and the consequences for an individual’s well-being of ending up with insufficient assets in old age are great. In short, “humans” find it difficult to understand the value of annuitization. Advising them about this, but then leaving it up to them to annuitize on a voluntary basis is simply not going to work in many, if not most, cases.

The guarantee of an income for life provided by an annuity is likely to be essential for the vast majority of retirees who need the security of a lifetime income. Even those with extensive wealth should consider annuitization to avoid the risk that an intended bequest will instead be needed for income in later life. So our view is that the issue should not be about whether annuitization of pension fund assets (and, indeed, nonpension assets) should be the default, rather it should be about the point at which annuitization should apply and what level of wealth needs to be annuitized. We believe that there is an optimal time and level of wealth to annuitize and these will be a function of the plan member’s age or life expectancy, gender, marital status, level of total assets, attitude to risk, desire to leave a bequest, and the fairness of annuity pricing.

For those with a low level of total assets (the mass market), annuitization of most of the accumulated pension pot—having taken out a lump sum to provide the “rainy day” fund—is likely to be the best strategy. For those with greater resources (the mass affluent), the level of annuitization at retirement should be sufficient to secure, at the very least, a minimum income level to meet “essential” expected needs (allowing for any state support). However, a higher level of base income will be required to achieve an “adequate” lifelong living standard. Having secured this, the plan member can then have some flexibility over the management of remaining assets to achieve a “desired” standard of living. This flexibility can continue until the time comes—which will again depend on age or remaining life expectancy, health, and the size of the available mortality cross-subsidy—to secure desired bequests, at which point the plan member might consider further annuitization. All market segments should consider using insurance to cover possible spikes in expenditure in retirement.

The key philosophy behind SPEEDOMETER plans is this: if it is good advice at some point in the life cycle to be smart and “save more tomorrow,” it must be the case that at a later point in the life cycle, having hedged your longevity and care risks, secured a desired income for the remainder of your life and made allowance for inheritance, the smart thing to do is “spend more today safely,” secure in the knowledge that you will be able to continue to live your life to the full however long you may live.

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