

Managing Retirement Incomes: Financial literacy, cognitive decline and retirement wealth decumulation choices

Professor James Banks
Department of Economics, University of Manchester
Senior Research Fellow, Institute for Fiscal Studies, London

Overview

- Most of the debate on population ageing and savings has been about the need for people to save more to provide for longer retirements
- But we must not forget the decumulation phase of the life-cycle
 - People will need to manage their money in their increasing long retirements and at increasingly older ages. And what they need to do is becoming more complicated over time
- This talk discusses some of the issues that arise
 - For more details: Banks and Crawford paper in *Annual Reviews of Economics*
<https://www.annualreviews.org/doi/abs/10.1146/annurev-economics-051420-014808>

Background 1: Microeconomic

Individuals need to start planning around surviving to the ages where their cognitive function begins to decline

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

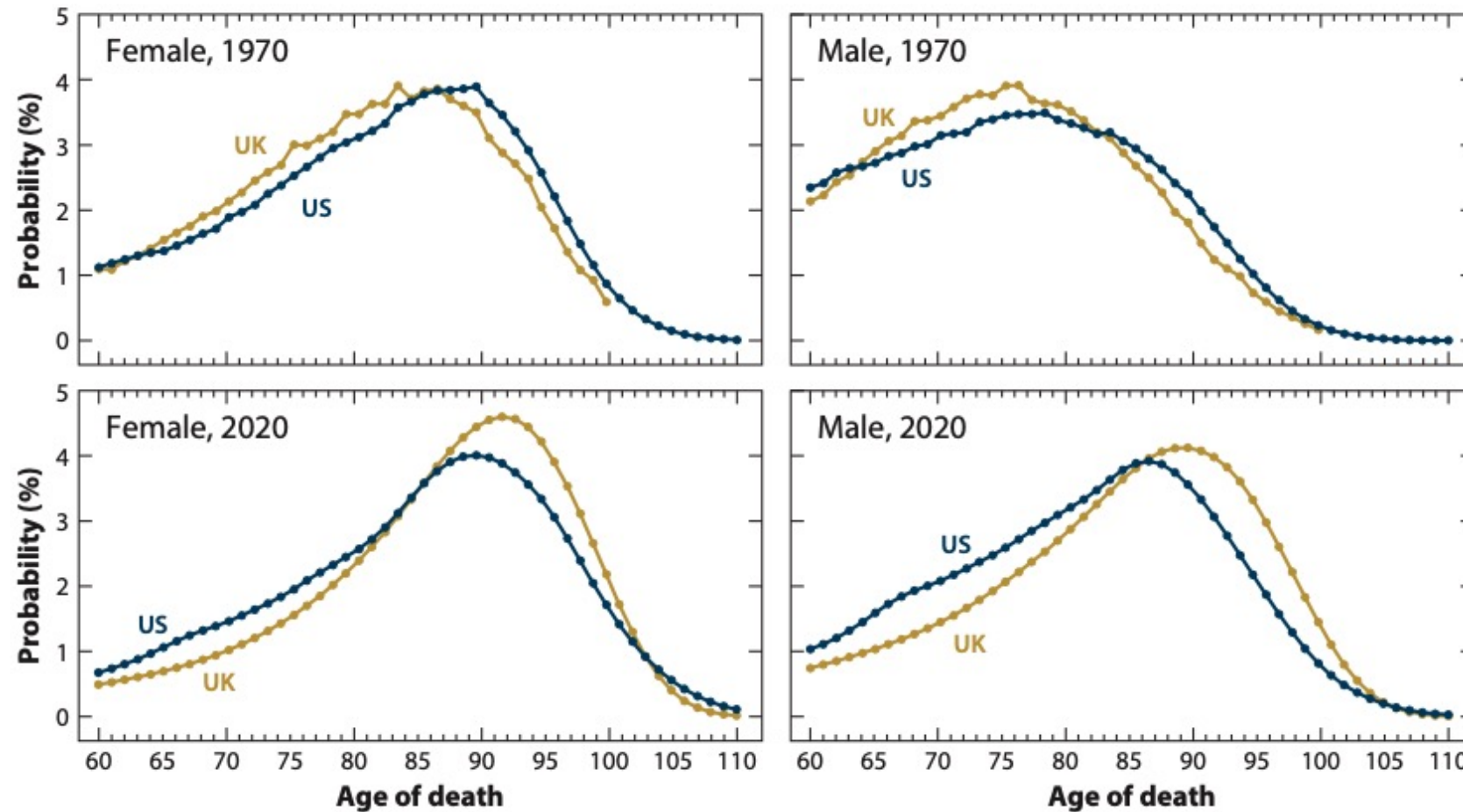
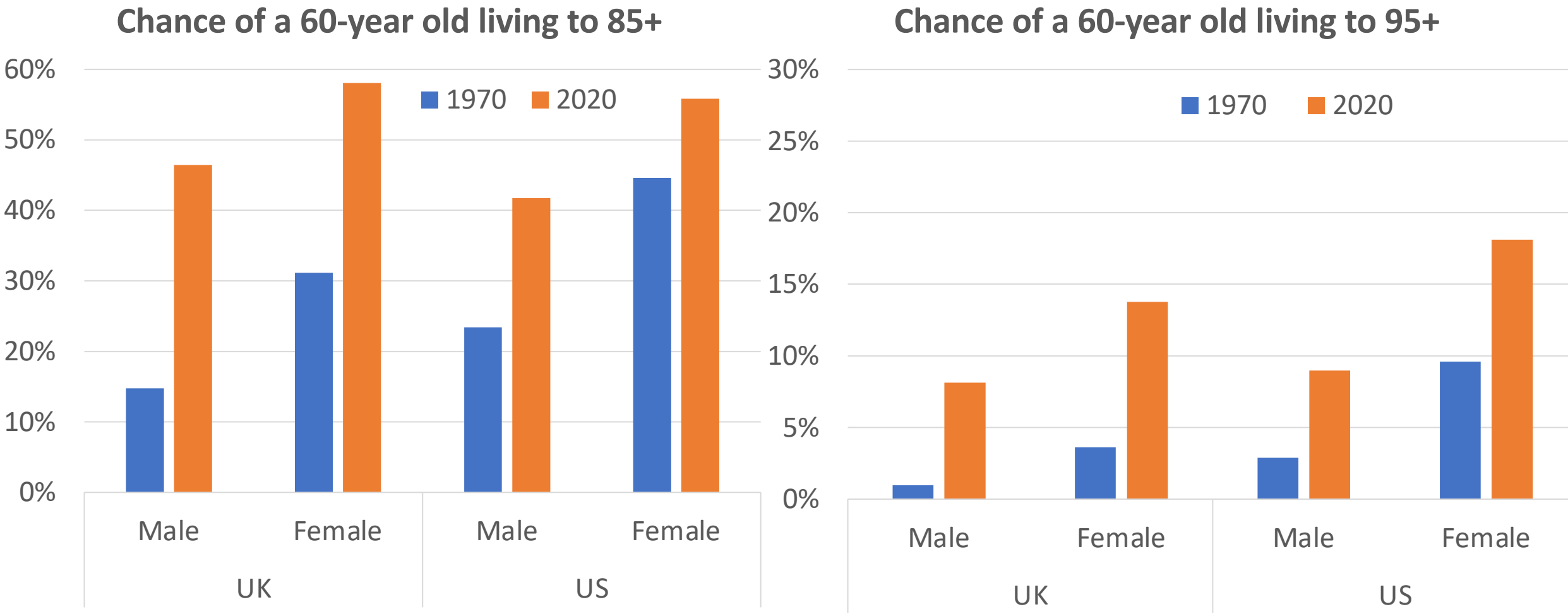


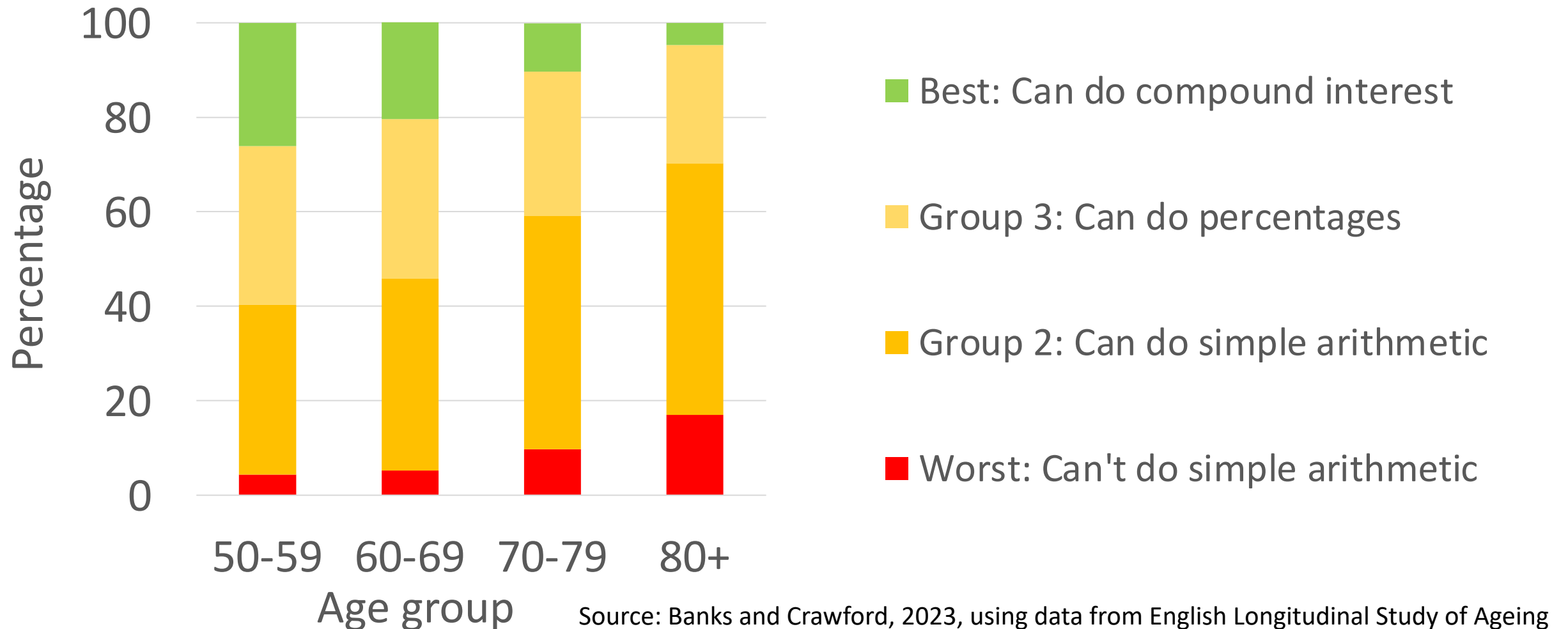
Figure 3

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).

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Cognitive abilities decline at older ages

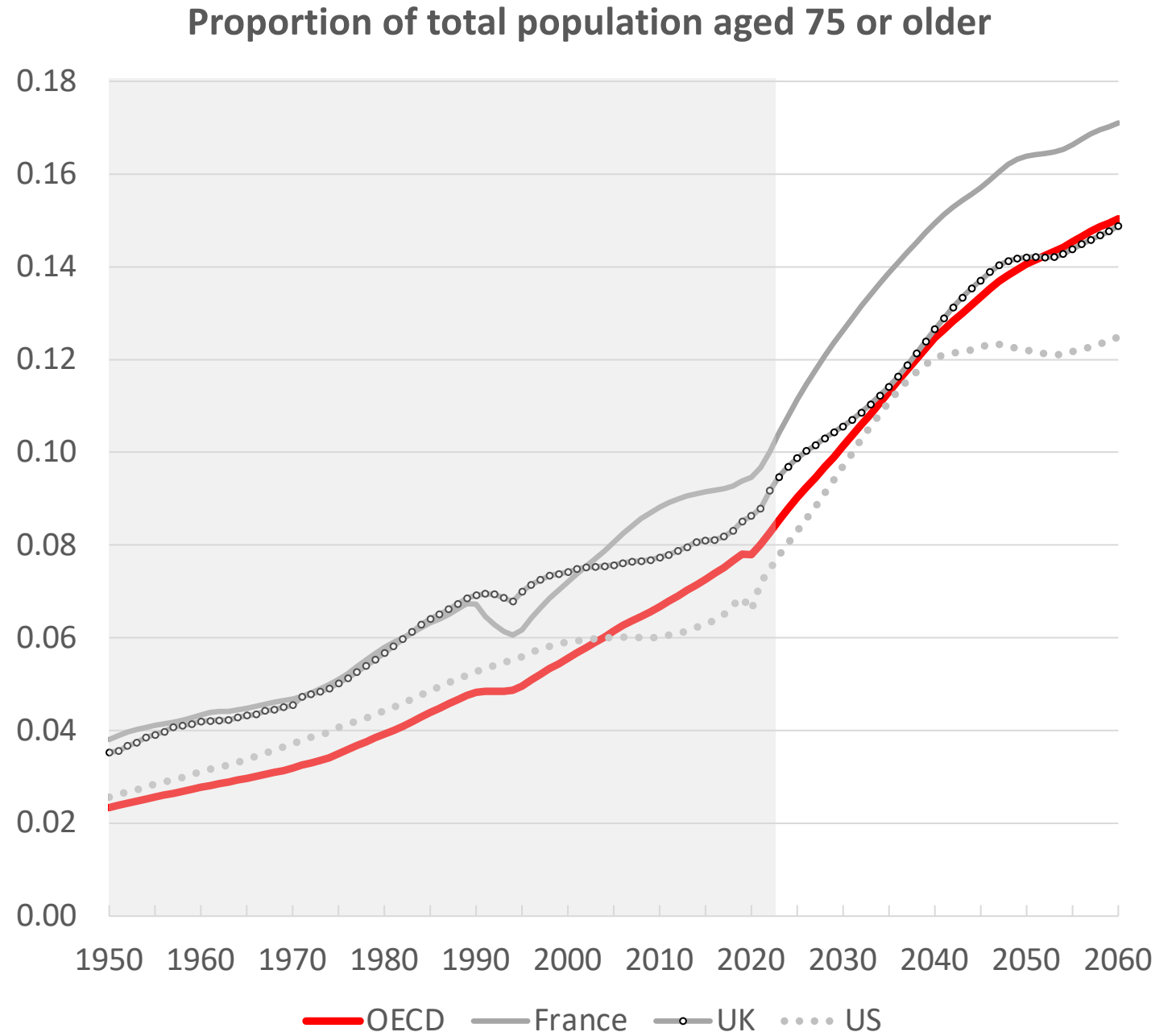


Background 1: Macroeconomic

The proportion of the population, and therefore of financial decision makers, who are at older old age is going to rise rapidly. And at the same time there is more of the economies wealth held in DC assets where active decisions need to be made.

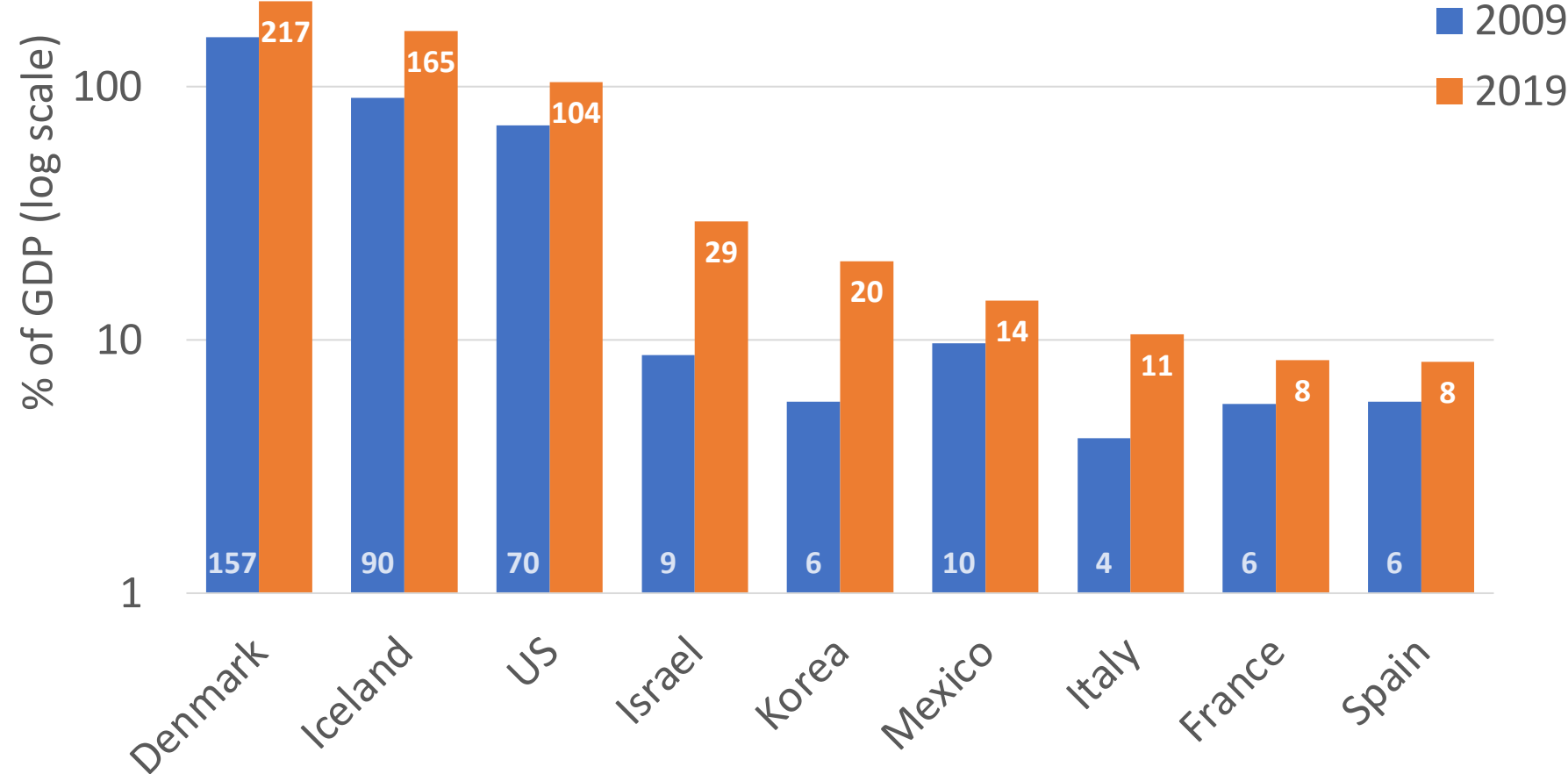
The proportion of the population over 60 has been rising since around 2010 as the baby boomers reached retirement age.

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



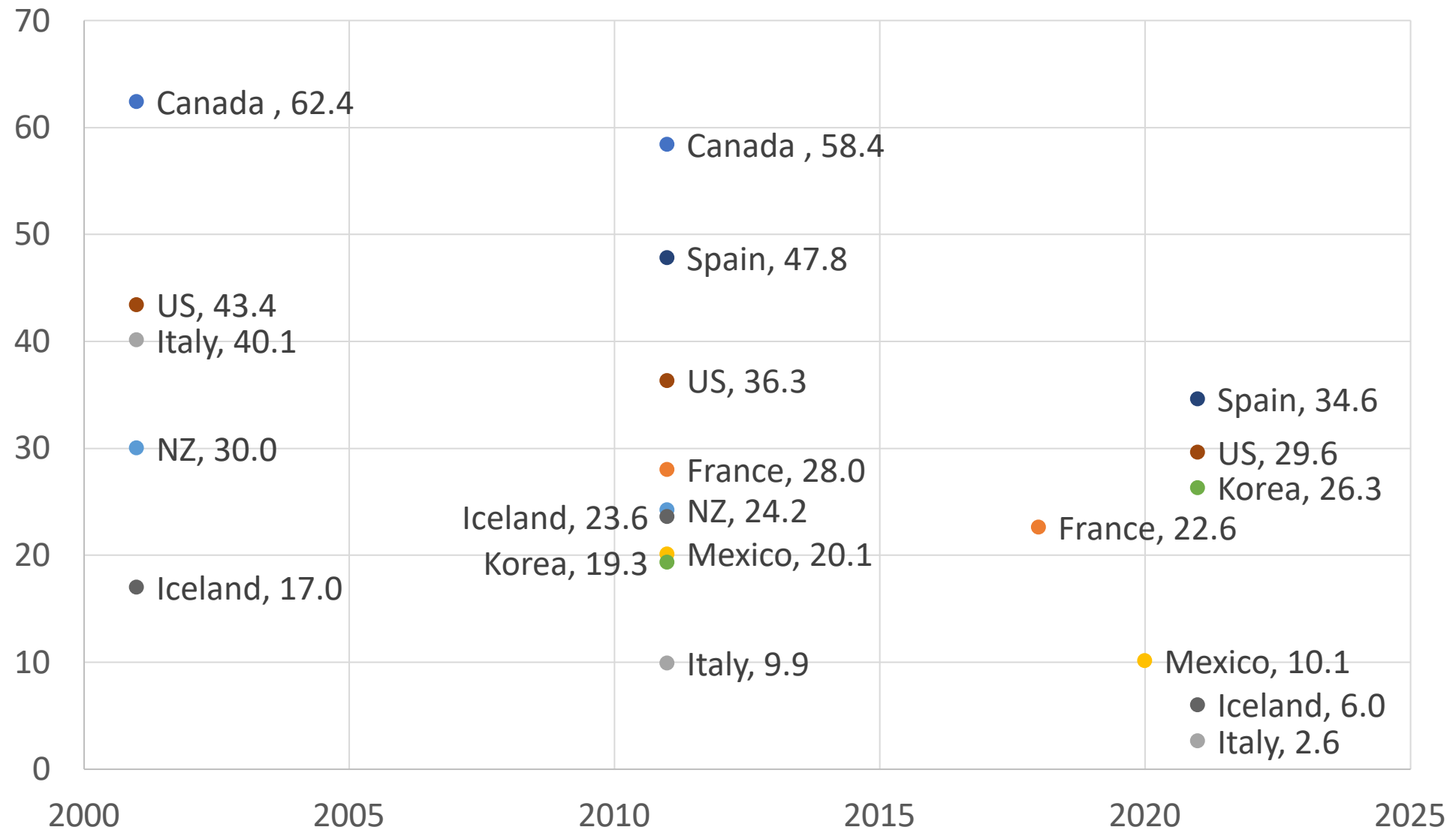
Source: OECD.stat

Defined Contribution pension assets becoming more important around the world



Source: OECD Pension markets in focus, 2020

Share of pension assets in DB (%)



What do we know?

What does existing evidence tell us about how older individuals manage their retirement incomes? And what do we know about the management of Defined Contribution funds?

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 beginning to be able to ‘explain’ the shape of average consumption trajectories post-retirement

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/>).

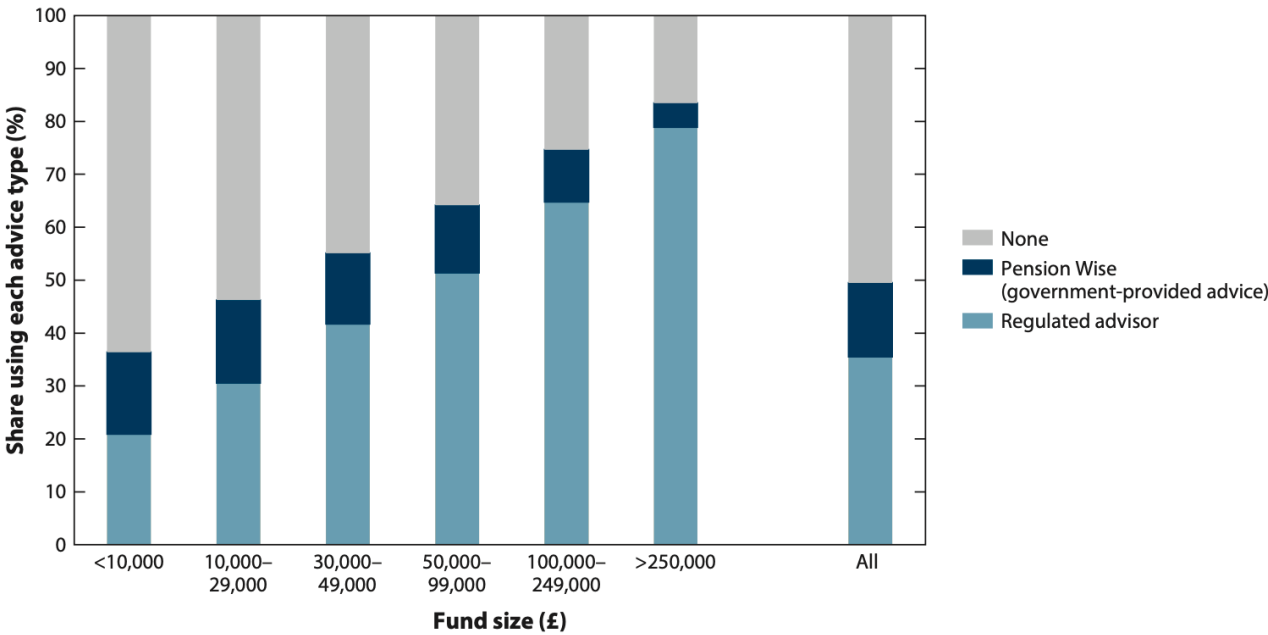


Figure 4 Use of advice for funds accessed for the first time in 2019–2020. Authors’ calculations based on data from Financ. Conduct Auth. (2020).

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- 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

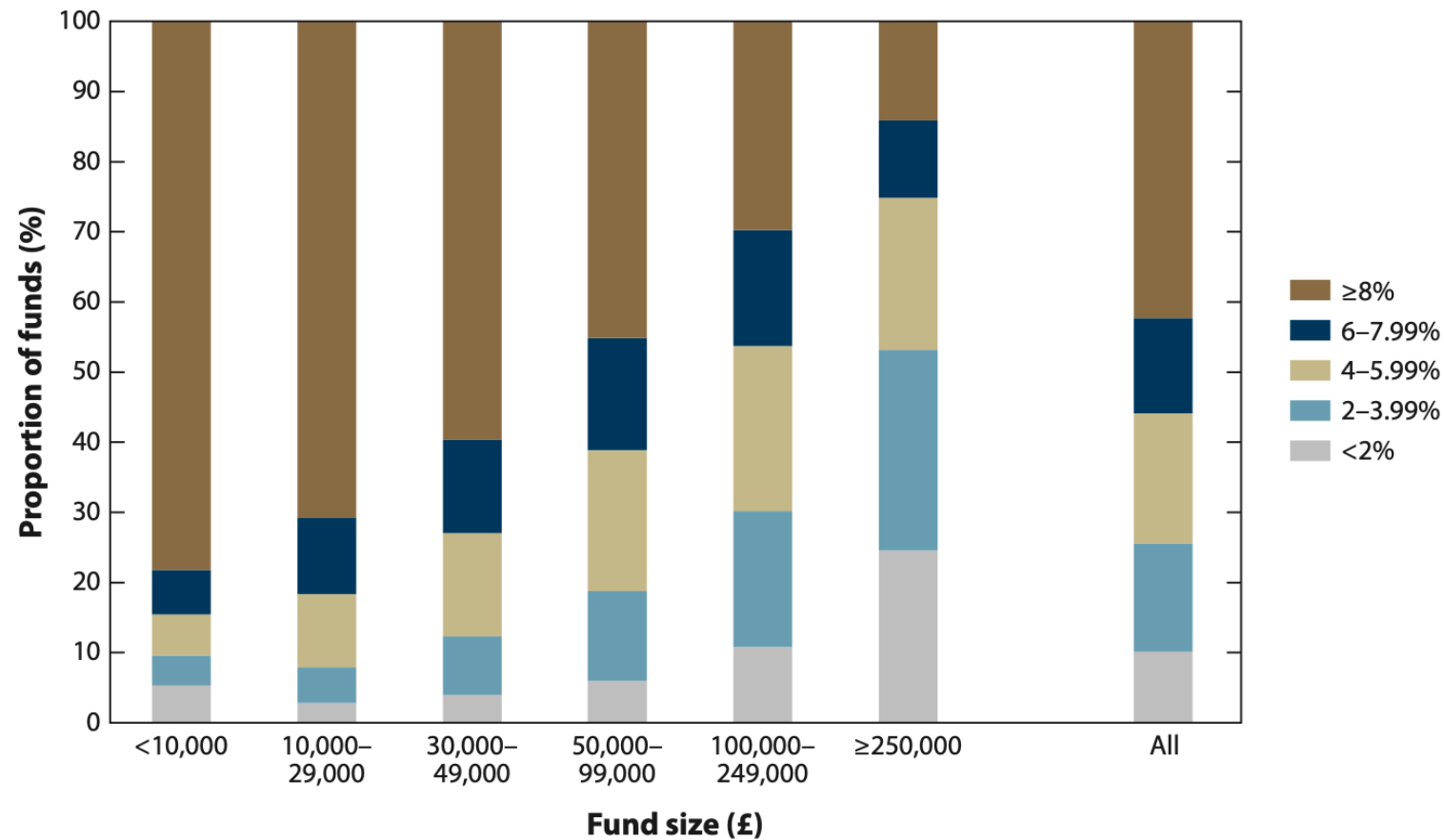


Figure 6

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

What do we need to know?

Applied research on financial literacy, cognition and decision making, pension withdrawals, portfolio allocations and consumption smoothing needs to be brought together

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

- The DC / individual 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 choices

Better data and more research needed

- 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 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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