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Fixing Defined Contribution: A five-pronged approach

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In this paper, we provide a flavour of what needs to change if defined contribution (DC) outcomes in the UK are to improve materially and sustainably and good outcomes are to become the norm. Spoiler alert: it isn't just the one silver bullet that'll fix DC.

Executive summary

- The UK has moved from a system of generous pension provision, collective passivity and certain outcomes, to one that is decidedly less generous, which entails much greater individual engagement and decision making and results in much less certain outcomes. Given this, a whole generation are potentially facing a worsening retirement outlook.
- The move from defined benefit (DB) to, the enforced default of, defined contribution (DC) started during the noughties following the dotcom bust, the introduction of mark-to market accounting for DB schemes and the global financial crisis.
- While automatic enrolment (AE) has dramatically increased workplace pension participation and seen active DC membership overtake DB, DC assets only represent 19% of total UK pension fund assets.
- As legacy DB benefits increasingly disappear, in the absence of a dramatic increase in DC contribution rates and stellar long-term investment performance, the state pension will increasingly become the mainstay of most retirement outcomes. This is evident from UK net (after tax) pension replacement rates trailing OECD averages and median DC pension pots at State Pension age forecast to grow from £38,000 today to only £63,000 in 2041 (in 2021 money terms). Despite this, savers' expectations of the standard of living in retirement their pensions pot will support continue to be severely misaligned with the reality.
- Five measures are required for retirement outcomes to improve both materially and sustainably: 1. Improving AE coverage and raising minimum AE contribution rates; 2. Encouraging greater DC saver engagement; 3. Making more widespread the provision and signposting of simple and easily accessible tools, guidance and low-cost advice to aid informed decision making and enable more decisive action; 4. Optimising DC savers' investment returns, and 5. Focusing on Value For Money.
- Ultimately, whether a minimum, moderate or comfortable retirement becomes the norm, is largely contingent on timely and decisive action or continued inaction by both the pensions industry and by policymakers.

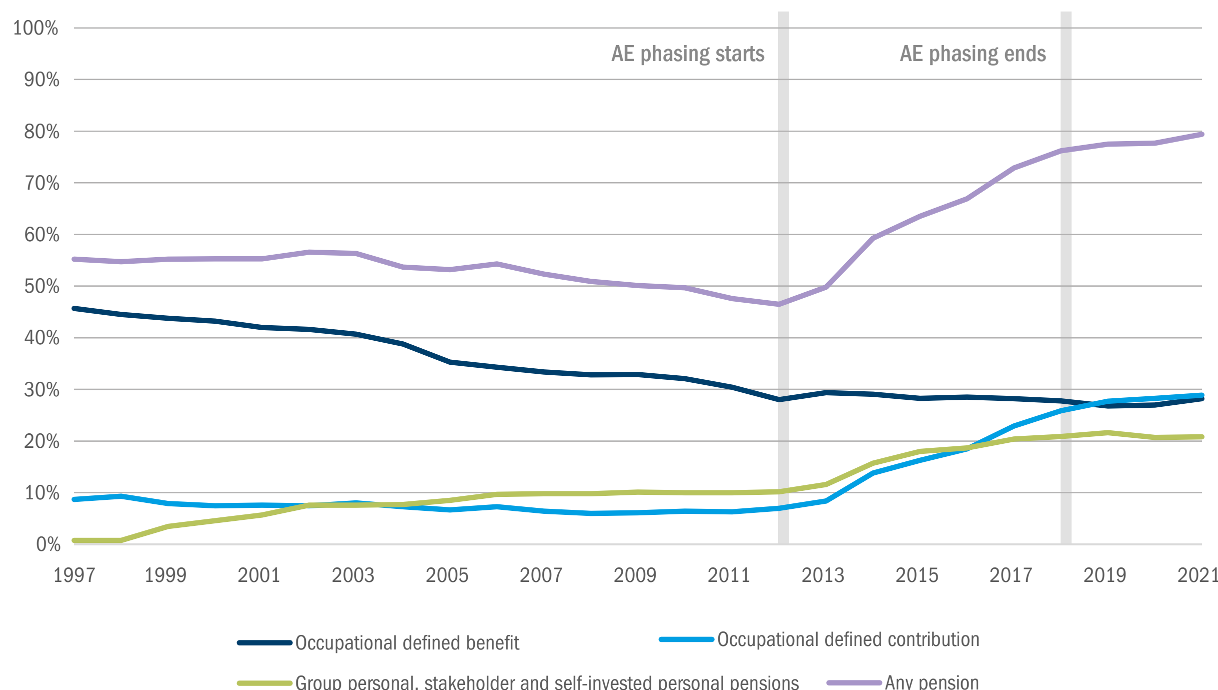
How DC became the enforced default

Back in the 1990s and early noughties, the vast majority of those in pensionable employment enjoyed the security and generosity of defined benefit (DB) pension scheme membership. By contrast, defined contribution (DC) was almost nowhere to be seen. Then came the perfect storm.[1] The dot.com bust of 2000/03[2] saw DB asset values plummet, while the introduction of mark-to-market accounting and material improvements in DB member longevity saw liability values rocket. The result was a series of unpalatable and untenable hits and ongoing volatility to DB sponsor balance sheets and profit and loss accounts.[3] Shortly followed by the 2007/09 global financial crisis (GFC), and its turbulent aftermath, the prices of return seeking assets once again collapsed[4] and unprecedented declines in nominal and real (inflation expectations-adjusted) bond yields began to unravel, to the further detriment of liability values. With ever widening DB deficits to plug, the damage to DB had well and truly been done and the move to DC, at least in the private sector, was well underway.

[1] This was preceded in 1997 by Chancellor Gordon Brown introducing the abolition of tax credits on UK company dividends. This stopped DB schemes reclaiming the tax credits on the dividend payments from their UK equity holdings. This is often cited as the first nail in the DB coffin.
[2] See: https://www.visualcapitalist.com/sp-500-market-crashes/.
[3] The introduction of mark-to-market accounting in November 2000 meant that DB scheme asset values were no longer actuarially smoothed on a triennial basis, to eliminate the effect of adverse short-term asset market volatility, but were instead valued annually at market value, thereby capturing this, often unwelcome, volatility. Simultaneously, DB liabilities were valued, or discounted by, the AA corporate bond yield, rather than the previous methodology of effectively employing the, much higher, historic rate of return from equities, which consequently heightened liability values. Combined, these two measures, in one fell swoop, gave rise to gaping DB deficits.
[4] See: https://www.visualcapitalist.com/sp-500-market-crashes.

The ever-increasing dominance of DC

Figure 1: Proportion of UK employees with workplace pension by type of pension. 1997 to 2021



Note: The data splits DC into: 1. trust-based occupational DC, and 2. contract-based occupational and non-workplace DC. The percentage employee participation in DC as a whole can be obtained by subtracting the “occupational defined benefit” line from the “any pension” line.

Source: Employee workplace pensions in the UK, 2020 provisional and 2021 final results. Office for National Statistics. 20 April 2022.

The increasingly rapid transition, in the private sector, from DB to DC, as depicted in Figure 1, has coincided with both increased worker mobility, as the notion of a job for life has rapidly dissipated, and the automatic enrolment (AE)-driven acceleration in overall workplace pension participation.[5] Indeed, between AE’s inception, in October 2012, and April 2021, a distinctly unhealthy 46.5% pensions participation rate was transformed to a, much healthier, 79%. AE has also been the principal driver of the dramatically increased participation in trust-based occupational DC schemes, not least via master trusts, which, in turn, has usurped DB as the dominant occupational workplace pension medium since 2019 (2014 if occupational contract-based and non-workplace DC is taken into account).[6] Despite this, UK DC only accounts for 19% of total UK pension assets.[7] Not that this should come as any great surprise. After all, we have moved from a system of generous pension provision, collective passivity and certain outcomes, to one that is decidedly less generous, which demands much greater individual engagement and decision making and results in much less certain outcomes. As a consequence of the ever-greater reliance on DC outcomes, at a time when the time spent in retirement is increasing,[8] addressing the inadequacy of retirement provision is one of the most pressing socio-economic challenges facing the UK.

DC outcomes are likely to fall short of expectations

Nowhere is the projected inadequacy of future retirement outcomes in the UK more evident than in the OECD’s current net pension replacement rates (NPRR) at State Pension age (SPa) for those having worked a full career.[9] Indeed, at 58.1% of net average earnings and 47.7% of double average earnings net of tax, the UK trails the OECD average.[10] This, despite a combination of legacy DB benefits still being prevalent; the UK’s SPa increasing, thereby lengthening the term many people will spend in the workforce contributing to their pensions; the uniquely generous annual uplift to the state pension; continually improving AE coverage and the increase, in April 2019, to the minimum employer and employee AE contribution rates. This also comes against the backdrop of other OECD pension markets becoming increasingly DC focused.[11]

[5] Automatic enrolment was introduced in October 2012. Employees are eligible if they earn more than £10,000 a year from a single employed position, are aged between 22 years and State Pension age (SPa) and are not already enrolled in a qualifying workplace pension.
[6] Office for National Statistics – Employee workplace pensions in the UK, 2021 provisional and 2020 final results. 20 April 2022.
[7] See: Global Pension Assets Study 2022. WTW Thinking Ahead Institute. 17 February 2022.
[8] According to the OECD, between 1970 and 2020 the average time spent in retirement, within the OECD, has increased by around eight years to 23.8 years for women and 19.5 years for men. See: OECD (2021), Pensions at a Glance 2021: OECD and G20 Indicators, OECD Publishing, Paris. p.180.
[9] See: OECD (2021). op.cit.p.145. Net replacement rates measure how effectively a pension system replaces an after-tax pre-retirement income with an after-tax retirement income, including the state pension, after a full career at SPa, across a range of after-tax pre-retirement income levels. A full career in the UK is defined by a 35-year NICs record.
[10] The corresponding OECD averages are 69.1% and 62.2%. The gross pension replacement ratio in the UK at SPa for average earnings is 49% and 38.2% for twice average earnings, versus an OECD average of 57.6% and 54.4%. See: OECD (2021). op.cit.p.147.
[11] Notably in Australia, Canada and the US, respectively the 5th, 4th and largest global pensions markets by assets. See: WTW Thinking Ahead Institute (February 2022). op.cit.

Further confirmation of this potentially ominous state of affairs is provided by Sir Steve Webb's evocatively titled 2021 paper *The Ski-Slope of Doom*,[12] the central tenet of which suggests that we're almost at the point of peak pensions, after which DC simply won't substitute for the abrupt decline of private sector DB pension rights. Indeed, in the absence of a dramatic increase in contribution rates and stellar long-term investment performance, the report notes that the state pension, which simply provides a basic standard of living in retirement, will increasingly become the mainstay of most retirement outcomes. Also aligned with this prospective prognosis is the C-grade sustainability rating applied to the UK pension system by the authoritative Mercer CFA Institute Global Pension Index.[13]

Setting the benchmark for a good retirement outcome

Defining what constitutes a good retirement outcome has been made easier by the Pension and Lifetime Saving Association's (PLSA) Retirement Living Standards.[14] The PLSA suggests, as a rule-of-thumb, that for a single person living in retirement outside of London, a gross income of £10,900, £20,800 and £33,600 will respectively provide a minimum, moderate and comfortable standard of living. For a couple, the corresponding numbers are £16,700, £29,600 and £49,700.[15] To put this into context, the median annual average gross total pay in the UK stands at £31,096.[16]

How far from achieving these outcomes is the UK projected to be?

An average earner, even with an assumed full 35-year NICs record at SPa would, in 2022/23 terms, only be entitled to a State Pension of £9,627.80. This is equivalent to less than one third of UK median gross pre-retirement income. That said, many of those at or near retirement today, who are not necessarily targeting SPa will, of course, have legacy DB benefits upon which to draw. However, as suggested earlier, these will increasingly disappear, thereby placing an ever-greater reliance on accumulated DC savings in retirement. And therein lies the problem.

According to the PPI, the median DC pensions pot in 2020 stood at £11,400 with median DC pots at SPa forecast to grow from £38,000 today to £63,000 in 2041 (in 2021 money terms).[17] Moreover, research from Pensions Expert suggests that the average pension pot in a master trust, increasingly the DC savings medium of choice, is only worth £4,147.[18] That's not to say there aren't those with several, indeed multiple, DC pots – of course there are. However, according to research from the Department of Work and Pensions (DWP) of large DC schemes[19] and the small pots working group,[20] which mainly considered master trusts in its research, of 11.2 million deferred DC pension pots, 74% were found to be smaller than £1,000, with a quarter of these worth less than £100 – a pot likely to be whittled away by fees and costs. Of course, these points simply reinforce the central tenet of Sir Steve Webb's paper.

Crucially, based on the best annuity rates available today, even multiple DC pots amounting to, say, £100,000 (a figure well in excess of the projected median) would only secure an annual level lifetime income at age 60 of £5,349. If linked to annual increases in the RPI, this becomes a mere initial £2,683 per annum.[21] In other words, an amount which, even after taking the full state pension of £9,627.80 into account, is only just above that required to finance the PLSA's minimum standard of living in retirement. Accepted, most retirees now opt for income drawdown over an annuity, and would typically invest in higher yielding assets than those that underpin annuities. Nevertheless, based on current interest rate expectations, this provides an indication of what currently constitutes a guaranteed level of income over the average retirement.

So what needs to change?

Although good DC retirement outcomes result from the culmination of many factors, at a high level DC savers have three strategic imperatives: 1. to save enough during their working lives;[22] 2. to invest these savings appropriately to at least ensure the real (inflation-adjusted) preservation of capital, and 3. to ultimately utilise these accumulated savings sustainably throughout retirement. Framed in this way, it all sounds simple enough. However, very few DC savers manage to achieve the first and most critical of these actions, let alone the second and third. Indeed, most people are woefully ill equipped to successfully navigate the complexity and multiplicity of the decisions to be made. Despite this, savers expectations of the standard of living in retirement their pensions pot will support continue to be severely misaligned with the reality.

[12] The Ski-Slope of Doom – Is this the most worrying chart in pensions? Sir Steve Webb. LCP. April 2021. Also see: Pensions Watch - edition 8, for a reasoned overview of the paper.
[13] The sustainability score (35% of the Global Pension Index) is principally driven by a pension system's coverage of a country's employed and self-employed pension assets as a percentage of GDP and demographics – notably the old age dependency ratio - the ratio of a country's dependent population to its total working-age (those aged 15-64) population. Mercer (2021), Mercer CFA Institute Global Pension Index.
Available at: www.mercer.com/globalpensionindex.
[14] See: https://www.retirementlivingstandards.org.uk.
[15] Within London, the respective gross incomes are: for a single person £13,200, £24,500 and £36,700 and for a couple £21,100, £36,200 and £51,500.
[16] Source: Average weekly earnings in Great Britain: April 2022. ONS. 12 April 2022.
[17] See: The DC Future Book: in association with Columbia Threadneedle Investments. 2021 Edition. A Research Report by Lauren Wilkinson, Daniela Silcock and John Adams Published by the Pensions Policy Institute © September 2021.
[18] Pensions Expert research. March 2022. Data as at 1 January 2022. See: The surge of small pointless pots endangers AE credibility. Stephanie Hawthorne. Pensions Expert. 8 April 2022.
[19] Improving outcomes for members of defined contribution pension schemes. DWP. 11 September 2020.
[20] The small pots working group was launched by Guy Opperman, the Minister for Pensions and Financial Inclusion, on 22 September 2020. For more on the challenges posed by small DC pots and the possible solutions, see "The small pots problem" later in the paper.
[21] Source: Hargreaves Lansdown. 23 June 2022.
[22] Delaying saving for just a few years, or taking a break from saving during one's working life, can have a marked impact on the percentage of earnings that will need to subsequently be saved if one's standard of living isn't to suffer in retirement.

Granted, the solution doesn't lie in a single silver bullet. However, if viewed holistically, resolving these issues is far from intractable. Basically, it boils down to implementing just five measures: 1. Improving AE coverage and raising minimum AE contribution rates; 2. Encouraging greater DC saver engagement; 3. Making more widespread the provision and signposting of simple and easily accessible tools, guidance and low-cost advice to aid informed decision making and enable more decisive action; 4. Optimising DC savers' investment returns, and 5. Focusing on Value for Money. Get each of these right and retirement outcomes will improve, both materially and sustainably.

1. Improving AE coverage and raising minimum contribution rates

Automatically enrolling individuals to pensions saving is predicated on the idea that getting people to save into a pension, by requiring them to proactively opt out, rather than opt in, results in greater and more sustained levels of long-term saving. So, rather than letting peoples' natural inertia stop them from making the decision to save, this inertia instead keeps them saving within the workplace pension to which they've automatically been opted into.[23] Historically low opt out rates are testament to this.

However, despite 10.7 million people having been auto enrolled (AEd) into an occupational pension scheme since 2012, and almost 1m re-enrolled, a not insignificant 10.5 million of the UK's employed population remain ineligible for AE as a result of their age and/or level of earnings.[24] A disproportionate number of these are women working part-time. Then there's the nation's 4.2 million self-employed,[25] who also fall outside of AE, few of whom have any notable pension provision.[26] Indeed, despite The Pensions Commission, in 2004,[27] suggesting that if you're working you should be contributing to a pension[28] and 2017's Auto Enrolment Review, commissioned by the DWP, calling for reform to increase AE coverage,[29] ineligibility has continued to rise and the DWP has yet to act.

The solutions

The principal recommendations of 2017's Auto Enrolment Review, which collectively sought to increase median earners' private pension provision by over 40% and lower earners by over 80%, comprised: 1. lowering the AE age threshold from 22 to 18 and, 2. removing the lower band earnings limit from which AE contributions apply (£6,240 in 2022/23) so that contributions are calculated from the first pound earned. However, the £10,000 gross earnings from a single employment trigger at which an individual is AEd was upheld by the Review on the basis that to lower it would bring into AE those for whom it may not make economic sense to save.[30] There was also a recommendation to improve pension participation and retirement outcomes among the self-employed. However, this has also yet to be implemented.

To illustrate the potential impact of reform on AE coverage, the PPI has estimated that by reducing the AE entry age to 18 would increase eligibility by 700,000, while extending the £10,000 gross earnings floor from just one to multiple jobs, would boost eligibility by about a third (3.5 million).[31] Of course, the question remains as to whether £10,000 gross earnings is an appropriate AE entry point.

Then there's the widely acknowledged inadequacy of the minimum 8% AE contribution rate[32] which, as noted above, is applied to band earnings (£6,240 to £50,270 for 2022/23),[33] rather than from the first pound of earnings. Whereas there is a growing consensus on the need to raise the minimum AE contribution rate to between 12% and 15% (from the first pound of earnings), there is, of course, the risk of widespread opt outs being triggered by those AE pension savers who see this as a step too far - especially in the middle of a cost-of-living crisis and given the recent NICs increase.[34]

Consequently, there are those who suggest one or a number of the following solutions: a higher contribution rate falling principally on the employer, not the employee;[35] starting employees on higher minimum contributions but allowing them to opt down their contribution rate, rather than opt out of contributing completely; and introducing the automatic escalation of contributions for when the employee receives a pay rise, not before.[36]

[23] This simple behavioural intervention has been applied with great success, not only in the UK, but also in the US, Chile, New Zealand and more recently Canada and Ireland. This idea of "reversing the default", or harnessing the inertia, from opting in to opting out, was largely driven by the success many countries experienced with reversing the default for organ donor cards. These, so-called nudges, which typically harness the inertia of the disengaged, are well documented. (Nudges are designed to subtlety but predictably influence, rather than coerce, people's behaviour so as to make them, and typically society, better off, without harming or disadvantaging them or others in the process). See: Richard H. Thaler and Cass R. Sunstein. Nudge – The Final Edition. Allen Lane (2021). pp.3-8.
[24] To be eligible for automatic enrolment an individual must be employed, aged between 22 and SPa and earn at least £10,000 per year (the earnings trigger) from a single employment. Data as at 30 April 2022. Automatic enrolment declaration of compliance report. The Pensions Regulator. May 2022. It should be noted that as part of an employer's AE duties, employers must write to those employees who aren't eligible for AE telling them about their right to opt into, or join, a pension scheme. Intriguingly, voluntary participation among non-eligible employees has grown from 16% in 2012 to 38% in 2021, meaning AE has had a tangible positive effect outside of its target beneficiaries. See: Economic Research Council Weekly Digest. Auto-enrolment. 6 July 2022.
[25] Data as at 31 March 2022. See: https://www.statista.com/statistics/318234/united-kingdom-self-employed/
[26] According to MoneyHelper, only 31% of the nation's self-employed are paying into a pension. Moreover, pensions consolidator, Pensions Bee, maintains that "the self-employed in the UK are the least well-prepared for retirement, and risk being left dangerously exposed to poverty in later life." See: How does the gig economy affect pensions? Laura Miller. Pensions Bee. 10 December 2019.
[27] Chaired by Lord Adair Turner and reporting to the Secretary of State for Work and Pensions, the Pensions Commission was established in 2002 to review the adequacy and sustainability of the UK's private pension system. Publishing its findings in October 2004 and November 2005, its recommendations for a new policy direction led to auto enrolment being established. The UK pensions industry remains divided as to whether a new Pension Commission should be established to revisit and make recommendations on improving the adequacy and sustainability of the UK pension system. See: Industry experts divided on need for a new Pensions Commission. Sophie Smith. Pensions Age. 29 March 2022.
[28] See: https://www.instituteforgovernment.org.uk/sites/default/files/pension_reform.pdf
[29] See: Automatic Enrolment Review 2017. Maintaining the Momentum. DWP. December 2017. https://www.gov.uk/government/publications/automatic-enrolment-review-2017-maintaining-the-momentum
[30] On the basis that £10K almost aligns with the amount of the full single State Pension. See: DWP (December 2017). op.cit. p48.
[31] The PPI (September 2021). op.cit.
[32] Since April 2019, the minimum auto-enrolment contribution to an employee's pension savings is 8% of qualifying earnings – of which employers must pay at least 3% and the employee the remaining 5%.
[33] The qualifying earnings band sets out the portion of earnings on which the AEd employee and their employer have to pay contributions into a workplace pension.
[34] From the inception of AE to immediately before the pandemic, opt out rates have consistently hovered around 9%. However, a tipping point could quickly be reached if AEd employees notice a material reduction in net pay, with increased contributions compounding the NICs increase. Moreover, pension saving persistency rates which, while healthy at 70%, had started to dip pre-pandemic. Persistency rates measure the proportion of eligible employees automatically enrolled who have contributed for a period of at least three out of four years into their workplace pension.
[35] However, just as many DC savers are facing a cost-of-living crisis, so many employers are facing a squeeze on profit margins where they don't have the pricing power to pass on increasing supply chain costs.
[36] This, so-called, Save More Tomorrow approach, formulated by behavioural economists Shlomo Benartzi and Richard Thaler in 2004, and originating from the same behavioural school of thought as auto enrolment, enables DC savers to commit today to paying increased contribution levels only in the event of receiving future pay rises. By not having to pay any money today, and not experiencing any reduction in their current take-home pay, the individual delays this cost, thereby better aligning it with the (seemingly far off) future benefits that will ultimately accrue. We consider the importance of overcoming this, so-called, present bias, shortly. See: Richard H. Thaler, University of Chicago and Shlomo Benartzi, University of California, Los Angeles. Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving. Journal of Political Economy, 2004, vol. 112, no. 1, pt. 2.

However, if the experience of the Netherlands, one of the world's leading pension systems, is anything to go by, determining the level of minimum contributions, the split between employer and employee and the method of implementation requires a solid consensus to be built between policymakers, trade unions, employers and employees. Indeed, the UK's Work and Pensions Select Committee (WPSC) as part of its 2021/22 Inquiry into "Savings for Later Life", has recently issued a call for evidence specifically from employers and trade unions on whether, and, if so, when and how, minimum AE contribution rates should increase. In addition, the WPSC asks when and how the Government should implement the key recommendations from the 2017 Automatic Enrolment Review, whether the £10,000 earnings trigger should be lowered and whether auto enrolees should be able to opt-down if contribution rates increase.[37]

However, one thing is for sure, in the absence of stellar investment returns, contributions of 8% are unlikely to give pension savers the retirement to which they aspire or expect.

2. Measures to improve saver engagement

In assuming greater responsibility for their own financial futures doesn't mean DC pension savers should be left to their own devices in determining what a good retirement outcome to and through retirement looks like and how best to go about achieving it. Indeed, as noted earlier, most people are woefully ill equipped to do so, given the complexity and multiplicity of the decisions to be made, a general tendency to avoid making decisions for fear of regret, not to mention overcoming perhaps the biggest hurdle of them all: inertia. Moreover, establishing and realising a good retirement outcome, however defined, is especially problematic given: 1. the lack of frames of reference by which to gauge what is feasible and realistic to achieve to and through retirement; 2. the paucity of guidance by which to navigate the plethora of financial jargon and evaluate the bewildering array of complex and opaque choices, and 3. a widespread unwillingness or inability to pay for independent financial advice. Consequently, there remains a deep-seated reluctance to engage with pensions and retirement outcomes.

This lack of engagement, in part, emanates from deeply engrained behavioural, or cognitive, biases, which act as a barrier to informed decision making and compound sub optimal levels of saving. Thankfully, many can be addressed by applying relatively simple behavioural insights and interventions to harness the inertia of the disengaged and address many of the impediments to informed decision making for those willing and able to make an active decision. Of these cognitive barriers, present bias and anchoring are particularly prominent.

Present bias

Present bias is a behaviourally-driven focus on the short term. For many DC savers, the preference for spending today over deferring spending, by saving, until tomorrow, is particularly strong, reinforced by the possibility of being poor in retirement simply not registering as a tangible reality today. Additionally, many of these individuals find it difficult to visualise themselves as retirees in later life. So, what is the solution to this myopia, or present bias? Quite simply, better aligning the immediate costs and future benefits of saving, thereby making the costs appear less immediate and the benefits more immediate and salient. Initiatives include projecting an image of how someone might look 30 or 40 years from now so they can identify with their future self;[38] (as noted above) automatically escalating contribution rates whereby DC savers commit today to paying increased contribution levels only in the event of receiving future pay rises, and issuing a national lottery ticket for, say, every £100 per month saved, as people tend to focus on the prize (indeed, visualise themselves sitting on a big pile of cash) rather than the small probability of winning it.[39]

Anchoring

This inter-temporal preference for consumption over saving is compounded by the tendency of many DC savers to mentally "anchor"[40] pension contributions to the minimum contribution level applied by their workplace pension scheme in the mistaken belief that this will provide an adequate sum in retirement. This problem is particularly acute amongst those passive DC savers AEd to a workplace pension,[41] where AE minimum contributions are typically seen as target savings levels, having been endorsed by the government and therefore perceived as adequate. Arguably this mental anchoring is preventing savings levels rising to wholly more appropriate levels. So, once again, what is the solution? Well, as with overcoming present bias, introducing lottery tickets would help to move contribution levels above the minimum contribution "anchor". Simple messaging can also sustainably increase DC saving. For instance, using novel phraseology such as "save three days' salary per month" or "save your age multiplied by 10 per month". Another way to move the contributions "anchor" to a more realistic level is to reframe convoluted terms such as "pensions tax relief" as a "savers bonus", and using sufficiently, but not unpalatably, large numbers to illustrate how the bonus works, eg a £50 bonus is received for every £200 saved. Likewise, positioning employer contributions, especially those that match or escalate at a faster rate than employee contributions, as "free money", tends to encourage higher contribution rates.

[37] The call for evidence closed on 8 June 2022. See: https://committees.parliament.uk/call-for-evidence/2626/. A Private Member's Bill aiming to implement these recommendations is currently passing through parliament, with a second reading expected in the Commons this parliamentary session.
[38] See: Hal E. Hershfield, Daniel G. Goldstein, William F. Sharpe, Jesse Fox, Leo Yeykelis, Laura L. Carstensen, Jeremy N. Bailenson. Increasing Saving Behavior Through Age-Progressed Renderings of the Future Self. Journal of Marketing Research Vol. XLVIII (November 2011), S23–S37. http://vhil.stanford.edu/mm/2011/hershfield-jmr-saving-behavior.pdf.
[39] This probability insensitivity is called the affect effect. People generally overestimate the occurrence of favourable events and underestimate the occurrence of adverse events.
[40] Anchoring is when people latch onto a wholly irrelevant number that comes easily to hand when they are in unchartered territory and use it as a reference point in their decision making.
[41] Ironically, AE detracts from saver engagement.

Greater DC saver engagement is also frustrated by unnecessary complexity, often caused by pension providers, albeit unconsciously, not making it straightforward for DC savers to deal with them or engage with their pension provision. Commonly referred to as *sludge*,[42] many of these obstacles can be overcome by applying the, so-called, EAST framework.[43] This simple behavioural framework comprises making actions and prompts ***Easy*** (removing the “hassle factor” associated with performing the desired action, eg requiring just one mouse click to achieve the action, conveying clear messages, breaking down a process or the achievement of a complex goal into simple, manageable steps);[44] ***Attractive*** (using personalisation, simple and positive language[45] and visuals, appropriate media, and novel incentives, including gaming, to make a course of action appealing); ***Social*** (creating positive social norms by socialising desirable actions and behaviours and encouraging people to publicly commit to a plan of action);[46] and ***Timely*** (prompting individuals to change behaviours at those pivotal times in their lives when they are most receptive to engagement, eg birthdays, anniversaries and episodes of major change).

However, behavioural interventions, while effective, are best applied, not in isolation, but in conjunction with people being properly supported throughout the entire retirement planning and implementation process. In so doing, people will feel empowered to make better and more informed decisions. This is where the simple and accessible tools come in.

3. Employing simple and easily accessible tools, guidance and low-cost advice

Given that most DC savers don’t know what they don’t know, good guidance holds the key to generating better retirement outcomes.

Pre-retirement guidance

Indeed, the, long-awaited, introduction of the Money and Pensions Service’s (MaPS) pensions dashboard, prospectively in 2023, will be instrumental here. By being able to view all of one’s pension entitlements securely online in one place, in a simple, logical fashion and assess whether the projected level of income at one or a number of desired future points in time (accepting retirement is not necessarily a one-off event) will provide the desired standard of living in retirement (and how sustainable this level of income is likely to be before the pot runs dry),[47] should prove a powerful motivator to those able to improve on their contribution rates. This, at a time when most pension savers have multiple small pots which typically don’t follow the member as they move between jobs. Indeed, many pots are “lost” along the way. Indeed, once launched, the MaPS dashboard should be a prime and welcome source of guidance, supporting that made available by those EAST-savvy pension providers and platforms who seek to help pension savers navigate the complexities of pension decision making. However, if the MaPS dashboard is to drive better, more informed choices, or to provide pension savers with the information they need in order for them to then seek further guidance and/or advice before they make a decision, the dashboard and its data should be simple to access, very easy to interpret and customise and bang up to date.

At retirement guidance

Then, of course, there’s addressing the extent to which DC savers are making uninformed decisions when accessing their DC benefits in a post-freedom and choice world. Famously described by Nobel prize winning economist Bill Sharpe as “the nastiest, hardest problem in finance”, this complex decision-making process can come at a time in many people’s lives when financial literacy and cognitive ability often starts to decline. Indeed, the consequences of making a wrong decision at this juncture will rise over time as people increasingly become solely reliant on their DC pension pots to support their standard of living in retirement.

Although the solution is multi-faceted, most pensions practitioners would agree that when it comes to seeking impartial and informed guidance on the decumulation options available to pension savers under freedom and choice and their associated risks, Pension Wise, the free pension guidance service for the over-50s, is hard to beat. However, the take up for Pension Wise remains woefully low, (ditto seeking independent financial advice, given a widespread unwillingness or inability to pay for the latter). Indeed, although spending 45 minutes on a call with Pension Wise (as I have done)[48] aptly illustrates how better retirement outcomes can be achieved by approaching an ultimately complex series of decision via logical and well framed questioning within a series of simple steps, unfortunately the idea of automatically enrolling DC savers into Pension Wise appointments prior to accessing their DC benefits has been dismissed.[49] This is disappointing, as for many, within a largely unsupported and unadvised mass market, this could mean the difference between enjoying moderate living standards in retirement and spending retirement in penury. That said, DC schemes and providers can, and increasingly do, voluntarily offer to book members a Pension Wise appointment before they have made a final

[42] Sludge, a play on nudge, was introduced to the behavioural lexicon by Richard Thaler and Cass Sunstein, authors of the widely acclaimed and global best seller, Nudge – The Final Edition. See: Nudge (2021). op.cit. Chapter 8.
[43] See: EAST. Four simple ways to apply behavioural insights. The Behavioural Insights Team. 2014. For a fuller explanation of how the EAST framework, and behavioural interventions more generally, can be applied specifically to improve saver engagement and generate higher levels of saving, see: Mind the Gap: Overcoming the cognitive barriers to saving for retirement. Chris Wagstaff. Columbia Threadneedle Investments. June 2016.
[44] Even the smallest number of unnecessary steps or additional effort required by the DC saver can derail the whole process.
[45] Using positive words, or priming, encourages more positive behaviour. As John Paul Sartre once said, “Words are loaded pistols.”
[46] As social animals, our decisions are rarely made in a detached manner. Instead, we act on the information, opinions and actions of others and like to have our own actions and opinions validated by others.
[47] Just as a motorist’s SatNav converts speed, distance and known roadblocks into a single ETA, the pension saver also needs to know what their probable end game looks like, conveyed by a simple, easily comprehended estimated retirement income number. For more on what constitutes a sustainable income withdrawal rate in retirement, see: Generating retirement outcomes to be enjoyed and not endured: Why we must harness the opportunities and overcome the risks at and in retirement in a world of freedom and choice. Chris Wagstaff. Columbia Threadneedle Investments. February 2018. pp.26-35.
[48] This is my attempt at helping the Pension Wise socialisation process along.
[49] See: Government rejects call for automatic Pension Wise appointments. Sonia Rach. Pensions Expert. April 2022.

decision on accessing benefits. Additionally, since 1 June, workplace DC schemes have been required to include a link to the Pension Wise booking tool in response to member applications to receive "flexible benefits". However, this "stronger nudge" may not be enough to make receiving pensions guidance immediately prior to accessing DC benefits, the norm. Moreover, guidance is not advice. Although in recent years the automated advice market has made considerable advances in the provision of low-cost advice to those at and in retirement, it is still at an embryonic stage. Therefore, the question of how to provide simple and affordable advice to those of a certain age, not least to those who are not tech-savvy, still needs to be answered.

4. Optimising DC savers' investment returns

Optimising DC savers' investment returns is an imperative both to and through retirement, not least at and in retirement in a world of freedom and choice, where the number of income drawdown contracts continues to far outstrip the number of annuities purchased. But first, to retirement.

To retirement

Given the enormity of the structural and behavioural challenges and impediments most DC savers face in the accumulation stage, in making an active investment choice (choice overload and inertia at work again), for most utilising a fit-for-purpose default strategy and default de-risking glidepath to retirement arguably remains their best possible option. Indeed, perceiving this as the recommended investment medium, most DC schemes see 95+% of members invest in the default fund and adopt the pre-retirement glidepath, typically for the full term of the pre-retirement journey (inertia yet again). Therefore, the default fund and glidepath needs to be capable of performing a considerable amount of intelligent heavy lifting if, in the continued absence of a material increase in DC contribution rates and members' changed circumstances over the course of the accumulation period, at least a modest, ideally a comfortable, retirement outcome is to be generated.[50]

However, while an increasing number of DC default funds now adopt a multi-asset fund mix, rather than a pure equity focus, a considerable number, in seeking to achieve an inflation-plus absolute return objective, fail to fully diversify across a multitude of diverse return drivers and risk premia. Moreover, most DC default funds, despite benefitting from positive DC saver cash flow and a long investment time horizon, still predominantly invest, via insurance platforms, in highly liquid asset classes. Consequently, most are missing out on the many longer-term less liquid, or less easily realisable, asset opportunities and the associated illiquidity and complexity risk premia that populate the asset portfolios and returns of most larger DB schemes, which typically have a much shorter investment timeframe. This could amount to forgoing around a 1% per annum increase in long-run risk-adjusted returns.[51] Crucially, heterogeneous illiquid real and alternative assets, such as private markets, real estate, social and economic infrastructure and social and affordable housing, also offer a markedly different risk-return profile and pattern of returns to that of public equity and credit markets, upon which many DC default multi-asset fund mixes overly rely, while real estate, infrastructure and social and affordable housing, in particular, offer long-term cash flows that are often implicitly or explicitly linked to inflation, and returns that are typically less sensitive to the macroeconomic environment than publicly traded assets.

Of course, there are impediments, both real and imagined, to DC schemes investing in illiquid assets.[52] However, none are insurmountable.[53] Principal among these is accommodating the requisite increased due diligence, by advancing DC investment governance and innovative investment thinking to leading-edge DB standards;[54] accommodating the higher charges and performance fees commonly associated with illiquid assets within the AE 0.75% charge cap, and ensuring those insurance platforms, through which most DC schemes invest, undertake the necessary investment to offer and administer illiquid assets. Then, of course, there's changing the prevailing, and deeply engrained, cost minimisation mindset applied to investment to one of maximising the net value added. More on that shortly when looking at value for money.

At and in retirement

In a world of freedom and choice, with a paucity of accessible guidance and low-cost advice, and with very little shopping around and advice being taken by DC savers, the decumulation stage of the DC journey is fraught with difficulty. Crucially, those at and in retirement, seeking flexibility and income security in opting for income drawdown, as opposed to inflexible and low yielding annuities, must successfully navigate a myriad of largely unquantifiable risks. Financial market corrections, especially those occurring early in the decumulation journey (sequencing risk), unexpected inflation and longevity risk, which is typically underestimated, all threaten the preservation of capital and its ability to underpin a sustainable fixed real (inflation-adjusted) income withdrawal rate to support a desired standard of living throughout retirement. If not managed well, these risks can add up to an uncomfortable retirement at best or, worst case, lead to the retiree outliving their savings or living in penury in fear of the latter.

[50] The typical one-size-fits-all composition of most DC default funds is positioned to meet the (perceived, albeit infrequently surveyed) needs of as many of an often broadly-based scheme membership as possible. While, in one sense, this is the default fund's greatest strength, it can also be its greatest weakness in that it fails to distinguish between members' varying risk preferences and, to a degree, investment time horizons. This is also true of most default glidepaths, which begin a gradual mechanistic one-size-fits-all de-risking from a pre-determined point in the run up to the scheme's normal, or the member's chosen, retirement age.

[51] See: https://www.avivainvestors.com/en-gb/views/aiq-investment-thinking/2020/05/premium-for-illiquidity/

[52] In March 2022, the DWP sought views on proposals and draft regulations to improve the accessibility of illiquid assets for DC schemes, including the case for greater consolidation. See: Facilitating investment in illiquid assets by defined contribution pension schemes. DWP. 30 March 2022. However, having received mixed responses, the DWP is not progressing with further policy proposals on either at this time.

[53] For an explanation of each and how they might be overcome, see: It's time for investment to do more of the heavy lifting. Chris Wagstaff. Columbia Threadneedle Investments. June 2019. pp.18-23.

[54] In so doing, DC schemes would also be better positioned to integrate Environmental, Social and Governance (ESG), particularly climate, factors and sustainability themes, into their investment decision making. Much of this should flow from the continued consolidation of small and micro DC schemes.

Perhaps unsurprisingly, the contention is that most people will never truly engage with the complex decisions to be made at and in retirement, nor will they ever have the confidence and capability to select and successfully manage the retirement solution that most closely meets their needs. Therefore, the solution perhaps lies in auto enrolling people at the point of retirement into an institutionally-managed income drawdown default fund that manages both investment and longevity risks, by pooling the latter in a fair and transparent manner, and which offers a default fixed real income withdrawal rate, perhaps with an AE-style charge cap. Of course, the more engaged, who are better able and willing to make their own decisions could opt out of this default and, with regulated advice, create their own bespoke solution.

However, in allowing a degree of flexibility to the default's parameters, which in itself would require more accessible guidance and low-cost advice, the default could be finessed at set times and within certain parameters to meet individual preferences. Of course, the extent to which each feature could be flexed would, in some cases, be constrained by the flexing of the other features, the individual's age and the size of the remaining pot.[55] Crucially, underpinning this decumulation default would likely be a genuinely well-diversified multi asset fund, resembling the fit-for-purpose accumulation default described above, targeting a deliverable inflation-plus absolute return objective, while minimising volatility and sequencing risk, allied to a competitive charging structure.[56]

Finally, there's also an argument for nudging DC savers into purchasing a deferred annuity at retirement to provide greater income certainty much later in retirement. In other words, at and in retirement decision making shouldn't necessarily be a binary decision of income drawdown versus an annuity. The two routes to sustaining a desired standard of living in retirement can, in fact, be complementary.

Collective Defined Contribution (CDC) anyone?

Think of Collective Defined Contribution (CDC) as providing a halfway house between the generous pension provision, collective passivity and certain outcomes of DB and the greater individual responsibility, less generous and less certain outcomes of DC. Already a staple in the Netherlands, Canada and Denmark, CDC will soon start to feature on the UK pensions landscape, as a replacement for DB and possibly DC schemes.

As a "to and through" retirement solution, CDC seeks to iron out intergenerational inequality by more equally distributing the risks and benefits of pension provision between younger and older cohorts. This CDC does via a considered multi-faceted approach. Key is setting a target or "ambition" level of benefits to be paid as a pension for life with variable increases. To explain. Based on a fixed level of employer contributions, set for a fixed term of at least five years, after which they are reviewed, a CDC scheme, unlike DB, has the scope to redefine the benefits it offers if circumstances change, without the employer being required to pay shortfall contributions. As there is no DB-like sponsor underpin, there are no guarantees. So, whereas the amount of pension is based on salary and service years, just as it is for DB, if the fixed contribution rate and the investment returns prove to be insufficient to support this accrual, then the pension benefit will be necessarily lower than originally intended. However, and this is the really important part, by pooling money into a single fund, with a desired long-term asset mix, CDC pension arrangements allow the risks of investing (by smoothing returns) and longevity to be pooled. They also typically achieve lower costs than DC through economies of scale and permit greater and longer-term exposure to growth and illiquid assets than is commonplace in DC.

Subject to Parliamentary approval, draft legislation, which draws on the lessons from well- established CDC systems, will come into force in the UK on 1 August for single and connected employer Collective Money Purchase (CMP) schemes (as they're referred to in the legislation). The first scheme to take up a CMP in the UK will be the Royal Mail DB scheme, with The Pensions Regulator (TPR) authorising and regulating this and subsequent CDC schemes. TPR will also consult on extending CDCs to multi-employer schemes (multi-employer CDCs could work to give those on modest wages, good pensions, eg the care sector) and decumulation-only solutions.

[55] For more on finding a solution to the decision challenges faced in a world of freedom and choice, see: Wagstaff (February 2018). op.cit. pp.40-43.
[56] For an explanation of the virtues of using a multi asset fund, versus competing structures, to underpin a sustainable income withdrawal rate, see: Wagstaff (February 2018) op.cit. pp.26-35.
[57] For more on the design of the most established international CDC systems and the challenges facing and opportunities available to UK CDC schemes, see: CDC: International Insights. Lauren Wilkinson. The Pensions Policy Institute. Briefing Note 131. June 2022. Also see: Pensions Watch – edition 15. November 2021.

5. Focusing on Value for Money[58]

Value For Money (VFM) is one of those terms most people understand but find hard to definitively measure and benchmark. According to the Oxford English Dictionary, value for money is “something that is well worth the money spent on it.” In other words, the focus shouldn’t only be on cost but also what is received in return – that is, the net value added, or detracted. Never is this truer than in the world of DC, especially when it comes to asset management. After all, low fund management fees and charges, in isolation, do not necessarily imply good value, as factors such as the manager’s fund performance, the consistency and volatility of these returns, service levels and the quality of communications also impact DC member outcomes.

Accepting that investment returns are never guaranteed whereas costs are the one factor that can be controlled, the opportunity costs of solely focusing on charges rather than adopting a more holistic net value added mindset can be considerable. Indeed, prioritising the former over the latter, by not considering the potential value add and risk mitigating nature of more governance-intensive illiquid investment opportunities has, to some extent, compromised the economics of portfolio construction and long-run risk-adjusted returns of DC.

However, changing the prevailing cost minimisation mindset applied to DC asset management to one of maximising the net value added remains a challenge. This is particularly true within the world of charge-capped AE DC default funds. Although well intentioned, with the aim of ensuring that members receive VFM, the charge cap has instead seen a race to the bottom with very little spent on investment. Sadly, the result has, in many cases, been to stifle innovation and creative thinking to the likely detriment of member outcomes. That’s not to say that genuine cost savings shouldn’t be sought. Indeed, achieving genuine cost savings can translate into performance improvements which can, in turn, take some of the pressure off DC contribution rates. However, where a VFM assessment reveals poor value, it is vitally important to take steps to improve matters – for example retendering the mandate, simplifying it or seeking scale-related discounts, depending on the issue identified. Doing so should enhance DC member outcomes – sometimes considerably so.

The small pots problem

The average number of jobs held in a lifetime is 12.[59] With each of these jobs typically comes a DC pension. Few, if any, pots follow the member to their next job or are consolidated into a single pot. The result? A proliferation of small, expensive to administer, DC pension pots, many of which are likely to be eroded out of existence over time by fees and charges.

As noted earlier, according to the DWP in 2020, of the 11.2 million deferred DC pots within large DC schemes, principally master trusts, 74% were smaller than £1,000 – with a quarter of these being worth less than £100. Separately, the PPI predicts there could be 27 million small pots in master trusts alone by 2035.[60]

With the government having asked the pensions industry to come up with a solution, the formation of the small pots group, co-ordinated by the PLSA and the Association of British Insurers (ABI),[61] has proposed a tripartite solution: pot-follows-member,[62] multiple default consolidators, and member exchange between providers. In June, the small pots group recommended that the government enact legislation to resolve the issue.

Why does all of this matter?

As noted earlier, we have moved from a system of generous pension provision, collective passivity and certain outcomes, to one that is decidedly less generous, which entails much greater individual engagement and decision making and results in much less certain outcomes. Given this, a whole generation are potentially facing a worsening retirement outlook. This includes many of the nation’s 4.2 million self-employed, who increasingly operate in the gig economy, with its meagre pensions uptake and, of course, those 10.5 million employees likewise excluded from AE by virtue of their age and/or their salary not meeting the £10,000 minimum. Moreover, even those 10.7 million employees who do meet the AE criteria or the 12 million workers who participate in other qualifying pension schemes simply do not, on average, save enough to generate a moderate, let alone a comfortable, standard of living in retirement. This is evident from current and future projected median DC pension pot sizes. Then there’s the dwindling numbers of DC savers shopping around and using independent financial advice when accessing their DC pots.

[58] In September 2021, TPR and the FCA published a discussion paper: “Driving Value for Money in defined contribution pensions”, inviting views on developing a ‘holistic framework and related metrics’ to assess Value For Money (VFM) in DC pension schemes. The paper proposed a framework “that looks at value through three lenses: investment performance, customer service/scheme oversight and costs and charges”. TPR and FCA intend to seek further input from stakeholders over the coming months before finalising their proposals and state that the “Government has expressed its willingness to legislate to introduce the VFM framework for schemes regulated by TPR and we will work closely with the DWP to achieve this. We aim to consult on our proposals towards the end of 2022”.
[59] U.S. Bureau of Labor Statistics. “Number of Jobs, Labor Market Experience, and Earnings Growth: Results From a National Longitudinal Survey. 2019. On average, men hold 12.5 jobs, and women 12.1 jobs, with the frequency of job moves declining with age. Unfortunately, there isn’t an equivalent UK study.
[60] See: Pensions Expert (April 2022). op.cit.
[61] As noted earlier, the small pots working group was launched by Guy Opperman, the Minister for Pensions and Financial Inclusion, on 22 September 2020.
[62] This option was originally proposed by former Pensions Minister, Baroness Ros Altmann CBE, in 2015.

Of course, while the disproportionately central role likely to be played by the state pension, as DB pension rights become less prevalent, should prevent a deepening of the UK's above average old age poverty rate,[63] a lack of decisive policy action means far too many people, on current trajectories, are set to unwittingly sleepwalk into retirement penury and endure, rather than enjoy, a retirement after a lifetime of work. While the motivation and means exists to generate better retirement outcomes for today's 20-, 30-, 40- and even 50-somethings, what appears to be missing is the will to develop a better framework. Moreover, this framework could draw more extensively on good behavioural science, to not only challenge the sludge and present bias, or myopia, that prevents savers engaging with their pension provision, but to arrest the seemingly imminent decline in retirement living standards, by helping to guide people towards making more optimal decisions to and through retirement.[64]

Ultimately, however, behavioural interventions need to be accompanied by people, not being left to fend for themselves, but by being properly supported throughout the entire retirement planning and implementation process. People need to have their options, choices and potential outcomes explained and illustrated to them in a simple, clear, understandable, relevant and practical manner, assisted by the more widespread provision and signposting of accessible tools, guidance and advice. Only then will they engage with the process and feel empowered to make better and more informed decisions. Nowhere will information and guidance be prospectively better conveyed than by the MaPS pensions dashboard and informed guidance better imparted than by Pensions Wise. In fact, the pensions dashboard and Pension Wise are natural bedfellows.

Of course, if the inadequacy of retirement provision is to be successfully addressed and good retirement outcomes are to become the norm, then the foregoing must be complemented by a combination of better DC investment governance and ensuring savers receive value for money, not least by consolidating multiple small DC pots. And don't forget the virtues of CDC. In other words, whether a minimum, moderate or comfortable retirement becomes the norm, is largely contingent on timely and decisive action or continued inaction by both the pensions industry and by policymakers. The clock is ticking.

[63] The old age poverty rate defines the percentage of those aged over-65 who live on an income below the national median income. The UK's old age poverty rate stands at 15.5%, against an OECD average of 13.1% and a poverty rate of 12.4% for the UK as a whole. Moreover, a gender pensions gap also exists in this metric with 18% of women aged over 65, versus 12.6% for men, caught in the old age poverty trap. The OECD average of 13.1% is split 15.1% for women and 10.1% for men. See: OECD (2021). op.cit.p.187.

[64] See: Pensions Watch editions 6 and 8 at: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-6/; https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-8/

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