COLUMBIA THREADNEEDLE INVESTMENTS

Fixing Defined Contribution: A five-pronged approach

Chris Wagstaff, Head of Pensions and Investment Education, Columbia Threadneedle Investments provides a flavour of what needs to change if 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.

How DC became the enforced default

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. The resulting double whammy of plummeting DB asset values and skyrocketing liability values, not only culminated in a series of unpalatable and untenable hits and ongoing volatility to DB sponsor balance sheets and profit and loss accounts but also to ever widening DB deficits. With the damage to DB having been well and truly done, the move to DC, at least in the private sector, was well underway.

DC outcomes are likely to fall short of expectations

Indeed, the UK has now almost secularly 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. Although automatic enrolment (AE)[1] has, since 2012, dramatically increased workplace pension participation[2] and seen active DC membership overtake DB, DC assets only represent 19% of total UK pension fund assets.[3] Consequently, a whole generation are potentially facing a worsening retirement outlook.

This is evident from UK net (after tax) pension replacement rates trailing OECD averages[4] and median DC pension pots at State Pension age (SPa) forecast to grow from £38K today to only £63K in 2041 (in 2021 money terms).[5] Moreover, 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. Despite this, savers' expectations of the standard of living in retirement their pensions pot will support continue to be severely misaligned with the reality.

So what needs to change?

At a high level, DC savers have three strategic imperatives: 1. to save enough during their working lives; 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. However, very few DC savers manage to achieve the first and most critical of these actions. Indeed, most people are woefully ill equipped to successfully navigate the complexity and multiplicity of the decisions to be made to and through retirement, avoid making decisions for fear of regret and suffer from inertia.

Consequently, 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.

[1] 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.

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

[3] See: Global Pension Assets Study 2022. WTW Thinking Ahead Institute. 17 February 2022.

[4] At 58.1% of net average earnings and 47.7% of double average earnings net of tax, the UK trails the corresponding OECD averages of 69.1% and 62.2%. See: OECD (2021), Pensions at a Glance 2021: OECD and G20 Indicators, OECD Publishing, Paris. p.147.

[5] 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.

1. Improving AE coverage and raising minimum contribution rates

Despite 10.7m people having been auto enrolled (AEd) into an occupational pension scheme since 2012, and almost 1m re-enrolled, 10.5m of the UK's employed population remain ineligible for AE as a result of their age and/or level of earnings,[6] (as do the nation's 4.2m self-employed,[7] few of whom have any notable pension provision).[8] The PPI has estimated that by reducing the AE entry age from 22 to 18 would increase eligibility by 700K, while extending the £10K gross earnings floor from just one to multiple jobs, would boost eligibility by about 3.5m.[9] Of course, the question remains as to whether £10K gross earnings is an appropriate AE entry point.

As to the minimum 8% AE contribution rate,[10] which is applied to band earnings (£6,240 to £50,270 for 2022/23),[11] there is a growing consensus on raising this to between 12% and 15% from the first pound of earnings. However, there is, of course, the risk of widespread opt outs being triggered.[12] Consequently, the following solutions have been suggested: a higher contribution rate falling principally on the employer, not the employee;[13] starting employees on higher minimum contributions but allowing them to opt down their contribution rate; and introducing the automatic escalation of contributions for when the employee receives a pay rise, not before.[14]

2. Measures to improve saver engagement

Realising a good retirement outcome is 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 and evaluate a 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, in part, emanates from deeply engrained behavioural, or cognitive, biases – present bias and anchoring principal amongst them[15] – 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 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.

Greater DC saver engagement is also frustrated by *sludge*[16] – unnecessary complexity, often caused by pension providers not making it straightforward for DC savers to deal with them or engage with their pension provision. Many of these obstacles can be overcome by applying the simple behavioural EAST framework, which makes actions and prompts *Easy, Attractive, Social and Timely.*[17]

However, while effective, behavioural interventions 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.

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, the introduction of the Money and Pensions Service's (MaPS) pensions dashboard will be instrumental in enabling all of one's pension entitlements to be viewed securely online in one place. This, when most pension savers have multiple small pots which typically don't follow the member as they move between jobs. Crucially, being able to 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),[18] and should prove a powerful motivator to those able to improve on their contribution rates.

[6]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.

[7]Data as at 31 March 2022. See: https://www.statista.com/statistics/318234/united-kingdom-self-employed/

[8]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.

[9]The PPI (September 2021). op.cit.

[10]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%.

[11]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.

[12]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 recent NICs increase.

[13]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.

[14]This 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 AE, enables DC savers to commit today to paying increased contribution levels only in the event of receiving future pay rises. By 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. 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.

[15]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. 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. Many DC savers mentally "anchor" 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.

[16]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: Richard H. Thaler and Cass R. Sunstein. Nudge – The Final Edition. Allen Lane (2021). Chapter 8.

[17]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.

[18]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.

At retirement, there is a need to address the extent to which uninformed decisions are being made when accessing DC benefits, in a post-freedom and choice world.[19] Although the solution is multi-faceted, when it comes to seeking impartial and informed guidance on the decumulation options available, 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).

Although since 1 June, workplace DC schemes have been required to include a link to the Pension Wise booking tool, 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. 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. 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), for most utilising a fit-for-purpose default strategy and default de-risking glidepath to retirement arguably remains their best possible option. Therefore, the default fund and glidepath needs to be capable of performing a considerable amount of intelligent heavy lifting. However, while most DC default funds now adopt a multi-asset fund mix, many, in seeking to achieve an inflation-plus absolute return objective, fail to fully diversify across a multitude of diverse return drivers and risk premia, despite benefitting from positive DC saver cash flow and a long investment time horizon. Crucially, most are missing out on the many longer-term less liquid asset opportunities and associated illiquidity and complexity risk premia that typically populate most larger DB schemes. Of course, there are impediments, both real and imagined, to DC schemes investing in illiquid assets though none are insurmountable.[20]

At and in retirement, with very little shopping around and advice being taken by DC savers, the decumulation stage of the DC journey for those seeking the flexibility and income security of income drawdown, is fraught with difficulty. Sequencing risk, unexpected inflation and underestimated longevity risk 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.[21] Given that most will never truly engage or have the confidence and capability to select and successfully manage the retirement solution that most closely meets their needs, the solution perhaps lies in auto enrolling people at the point of retirement into an institutionally-managed income drawdown default fund[22] that manages investment and longevity risks, in a fair and transparent manner, which offers a default fixed real income withdrawal rate, perhaps with an AE-style charge cap and allows a degree of flexibility to the default's parameters, to meet individual preferences. The latter would, of course, require accessible guidance and low-cost advice. 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. Necessarily, 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. Of course, once established in the UK, Collective Defined Contribution (CDC) may ultimately hold the key to better decumulation (and accumulation) outcomes.[23]

5. Focusing on Value For Money[24]

Value For money (VFM) is defined as "something that is well worth the money spent on it." Therefore, the focus shouldn't only be on cost but also what is received in return – that is, the net value added, or detracted. In the context of DC asset management, 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. However, changing the prevailing cost minimisation mindset applied to DC asset management to one of maximising the net value added remains a challenge, particularly to charge-capped AE DC default funds, which have seen a race to the bottom with very little spent on investment, to the likely detriment of member outcomes. This needs to change.

[19]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.

[20]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

[21]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.

[22]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.

[23]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.

[24]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".

Conclusion

As DB pension rights become less prevalent, 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 means exist to generate better retirement outcomes, what appears to be missing is the will to develop a better framework – one that could draw more extensively on good behavioural science, accompanied by people being properly supported throughout the entire retirement planning and implementation process, complemented by a combination of better DC investment governance and a focus on value for money. Only then might people engage with the process and feel empowered to make better and more informed decisions.

However, 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.

The full paper can be accessed at: https://www.columbiathreadneedle.co.uk/en/inst/insights/fixing-defined-contributiona-five-pronged-approach/

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