PENSIONS POLICY INSTITUTE

PPI

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THE DC FUTURE BOOK 2022:

IN ASSOCIATION WITH COLUMBIA THREADNEEDLE INVESTMENTS

The eighth annual report sponsored by

COLUMBIA THREADNEEDLE INVESTMENTS

ISSUE #8

About The Pensions Policy Institute (PPI)

We have been at the forefront of shaping evidence-based pensions policy for 20 years.

The Pensions Policy Institute (PPI), established in 2001, is a not-for-profit educational research organisation. **We are devoted to improving retirement outcomes**. We do this by being part of the policy debate and driving industry conversations through facts and evidence.

The retirement, pensions and later life landscapes are undergoing fast-paced changes brought about by legislation, technology, and the economy. Robust, independent analysis has never been more important to shape future policy decisions. Each research report combines experience with **INDEPENDENCE** to deliver a robust and informative output, ultimately improving the retirement outcome for millions of savers.

Our **INDEPENDENCE** sets us apart – we do not lobby for any particular policy, cause or political party. We focus on the facts and evidence. Our work facilitates informed decision making by showing the likely outcomes of current policy and illuminating the trade-offs implicit in any new policy initiative.

Our Vision:
Better informed policies and decisions that improve later life outcomes
We believe that better information and understanding will help lead to a better policy framework and a better provision of retirement income for all.

Our Mission:
To promote informed, evidence-based policies and decisions for financial provision in later life through independent research and analysis
We aim to be the authoritative voice on policy on pensions and financial and economic provision in later life.

Est. 2001

By supporting the PPI, you are aligning yourself with our vision to **drive better informed policies and decisions that improve later life outcomes,** and strengthening your commitment to better outcomes for all.

As we look forward now to the next 20 years, we will continue to be the trusted source of information, analysis, and impartial feedback to those with an interest in later life issues. The scale and scope of policy change creates even more need for objective and evidence-based analysis. There is still much to do, and we look forward to meeting the challenge head on.

For further information on supporting the PPI
please visit our website:
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Lauren Wilkinson, Senior Policy Researcher Pensions Policy Institute

Lauren Wilkinson joined the PPI in September 2016 as a Policy Researcher. During her time at the PPI Lauren has produced research on a range of topics, including Defined Benefit, consumer engagement, pension freedoms and Collective Defined Contribution.

Lauren was promoted to Senior Policy Researcher in January 2019.

Prior to joining the PPI, Lauren achieved an undergraduate Masters in Politics and Philosophy at the University of Glasgow, followed by a Masters in Public Administration and Public Policy at the University of York.

John Adams, Senior Policy Analyst, Pensions Policy Institute

John has been the PPI's Senior Policy Analyst since 2008. In his time at the PPI John has worked in a lead role in the modelling of a wide range of pension policy project number of PPI modelling projects including a number of projects looking at public sector pensions and pension related tax-relief.

At the PPI, John is responsible for the PPI's Pension Facts and has authored briefing notes and reports on subjects such as how housing wealth can support retirement, tax policy on pension schemes, harnessing pension savings for debt alleviation, public sector pension reforms.

John joined the PPI in 2008 from Hewitt Associates. At Hewitt he worked primarily on modelling of standard and non-standard Defined Benefit pension scheme calculations for the consultants to present to the clients.

Prior to joining Hewitt John worked for the Government Actuary's Department for 8 years in the Occupational Pensions directorate, during which time he calculated public sector pension scheme valuations, bulk transfer values, and designed models for the use of other Government departments.

John has a BSc in Actuarial Mathematics and Statistics from Heriot Watt and a Post Graduate Diploma in Actuarial Management from Cass Business School.

Daniela Silcock – Head of Policy Research, Pensions Policy Institute

Daniela is Head of Policy Research at the Pensions Policy Institute (PPI), and leads the Policy Research team. She has a wealth of experience in conducting quantitative and qualitative research into all aspects of state and private pensions policy, writing articles for journals and national press, and presenting to a variety of domestic and international audiences, including radio and television appearances.

Daniela originally joined the PPI in 2008 and took a short break in 2012 to work as a Committee Specialist for the Work and Pensions Select Committee.

Prior to working in research and policy Daniela was a social worker with vulnerable adults and children. Daniela has an MSc in Social Policy and Planning from the London School of Economics.

The DC Future Book 2022

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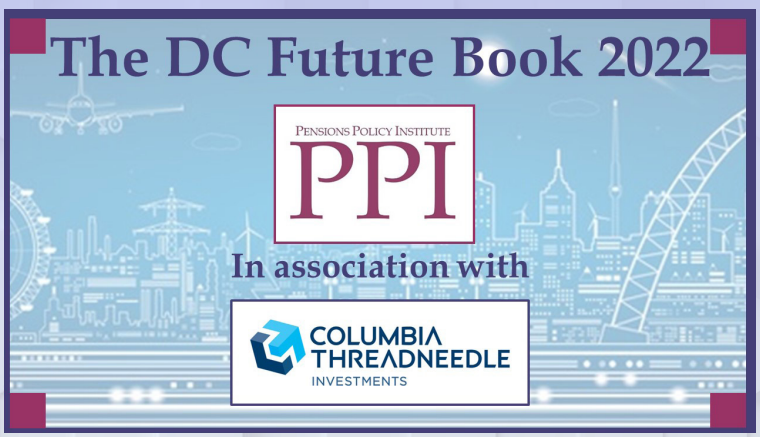

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The DC Future Book 2022: Foreword

I am delighted to introduce another highly informative edition of *The DC Future Book*, the eighth in a series of annual Defined Contribution (DC) publications by the Pensions Policy Institute (PPI) which Columbia Threadneedle is proud to have sponsored.

The last 12 months have seen extraordinary challenges. Between the ongoing effects of the Covid-19 pandemic, the war in Ukraine and additional supply chain constraints, inflation in the UK has reached its highest level in 40 years. As the PPI notes, unexpected and significant increases in inflation are likely to have far-reaching effects for people.

Chapter 4 of this year's edition addresses how different asset classes may respond to inflationary pressure, and how particularly illiquid assets such as real estate can be a good hedge against inflation. We would encourage those responsible for DC pension investment strategy to consider and respond to this new environment, in which inflation presents a considerable risk to DC pot values and therefore retirement outcomes.

Once again, *The DC Future Book* also carries plenty of other trend-based facts and figures that help to shine a light on the state of play of the UK DC pensions industry. Whilst in 2012, only 46.5% of employees participated in a workplace pension of any kind, by 2021 this number had grown to 79.4% thanks to auto enrolment being fully implemented. As a result, DC pension membership has hit successive highs at 13.8 million active members.

However, almost as many employees remain ineligible for auto enrolment due to their age or earnings. Of these, the vast majority are women. The PPI estimates that eligibility could increase by a notable 1.5 million employees if the £10,000 earnings trigger was to be removed, thereby automatically bringing in those with multiple jobs who would not be eligible under the current rules.

I encourage the pensions industry and policy makers to continue to consider how together we can help bring more financial security in retirement to employees across the UK. Columbia Threadneedle looks forward to partnering on this journey. *The DC Future Book* is a great source of information to help this reflection and I hope you enjoy reading this year's edition.

Michaela Collet Jackson
Head of Distribution, EMEA, at Columbia Threadneedle Investments

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Introduction

This report is the eighth edition of the Pensions Policy Institute's (PPI) The DC Future Book: in association with Columbia Threadneedle Investments, setting out available data on the Defined Contribution (DC) landscape alongside commentary, analysis and projections of future trends.

Demographic and policy changes mean that, compared to previous generations of pensioners, current and future retirees will:

- Live longer on average
- Receive their State Pension later
- Be more likely to reach retirement dependent on Defined Contribution (DC) savings, with little or no Defined Benefit (DB) entitlement
- Have greater flexibility when accessing and using their DC savings over the course of later life.

These changes increase the risk borne by pension savers and the complexity of decisions they must make at and during retirement. Given the potential risks involved for those retiring with DC savings, and the rapid expansion of the workplace DC market, it is important that a comprehensive compendium of DC research statistics and longitudinal studies is available to allow observation and analysis of developing trends.

Chapter One - What is the DC landscape?
Outlines the State and private pension system in the UK, and the main DC landscape changes over the past few years.

Chapter Two - What does the DC landscape currently look like?
Provides an overall picture of the current DC landscape, including data on automatic enrolment, saving levels, investment strategy, access to savings, and advice and guidance.

Chapter Three - How might the DC landscape evolve in the future?
Explores how the DC landscape might evolve in the future both for individuals and on an aggregate level, using PPI modelling.

Chapter Four - How will high inflation impact DC investment strategies?
Explores the current environment of high inflation, the challenges it poses for DC schemes and the options available to them for mitigating the risk to member outcomes.

Chapter Five - Reflections on policy
Contains reflections on the policy themes highlighted by the report from leading thinkers and commentators in the pensions world.

Chapter One:

What is the DC landscape?

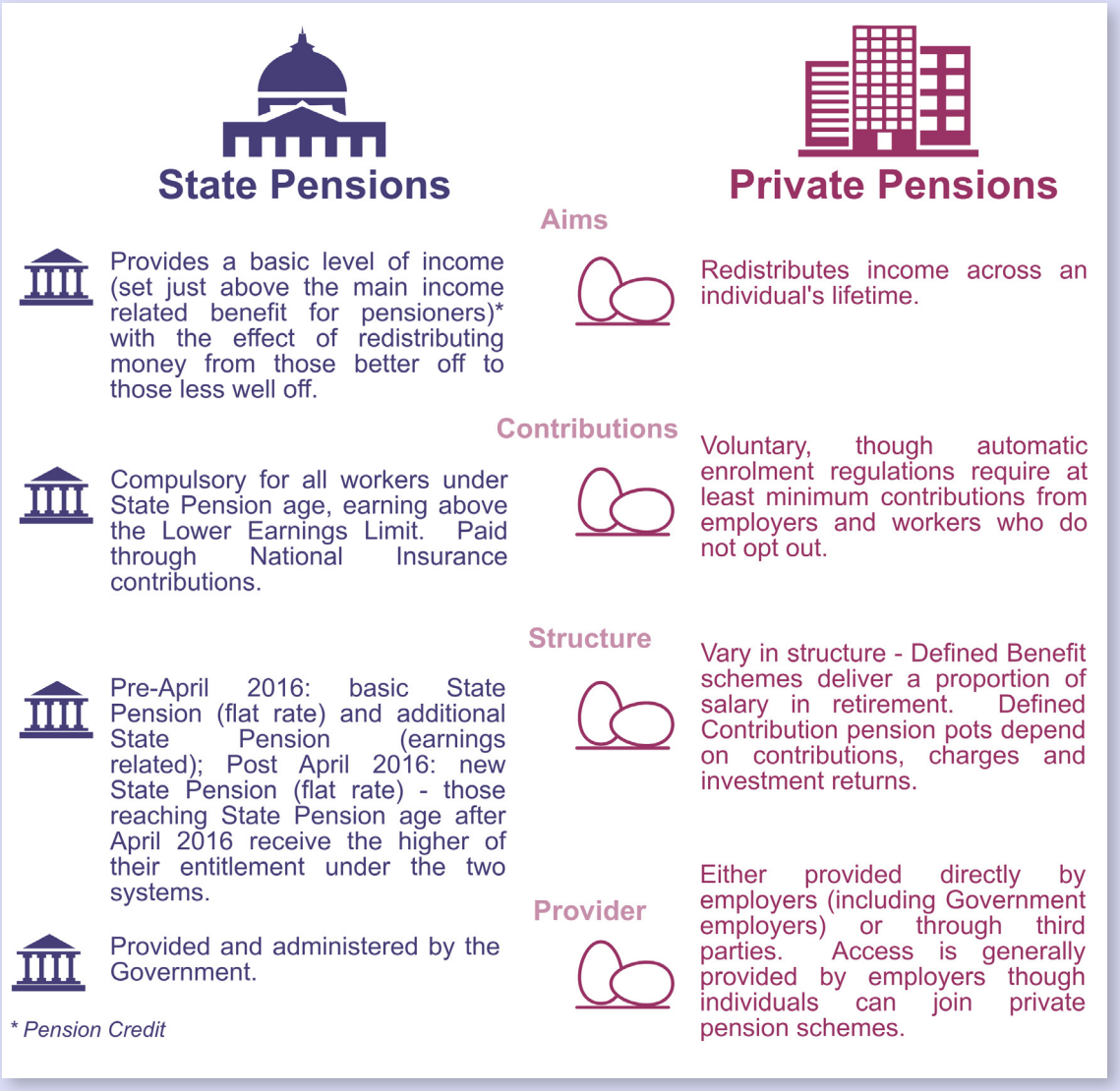
Chapter One: What is the DC landscape?

This chapter outlines the State and private pension system in the UK and the main Defined Contribution (DC) landscape changes over the past few years.

There are two main tiers to the State and private pension system (Box 1.1):

- A compulsory, redistributive State tier; and,
- A voluntary, private tier[1]

Box 1.1: The State and private pension system



Pensions in the private tier can be either workplace (provided through an employer) or personal (set up by the individual who has a direct contract with the provider). While workplace pension saving is more prevalent than personal accounts, the market for non-workplace pensions is relatively large, especially in terms of assets under management (AUM). Data from 2021 shows there to be around 13 million personal pension accounts, with total aggregate savings of around £470 billion held within.[2] Non-workplace personal pensions are used by people in self-employment who don't have access to a workplace pension, as well as people who want to supplement their workplace pension savings. This means that some individuals have both workplace and personal pensions at the same time.

[1] For further detail regarding the UK pension system, see PPI's Pension Primer (2022)

[2] FCA (2021a)

There are benefits associated with saving in private pensions over other types of saving

Private pension savings (along with other savings and assets) are used to top up State Pension income and improve people's standard of living in retirement.

Private pensions provide benefits over other forms of saving:

- Eligible employees enrolled in workplace pensions receive employer contributions.
- Pension contributions and investment returns are given tax relief (subject to certain limits).
- The long-term nature of pension saving allows for compound investment returns to accrue over time, which can substantially increase fund sizes.

However, there are also risks associated with private pensions

The most significant pension-related risk is the risk of not saving enough to achieve an adequate standard of living in retirement. Other significant risks are (Box 1.2):

Box 1.2[3]

Inflation risk is a particularly important consideration within the current economic landscape. The current high level of inflation and the impact it may have on DC pensions are explored in Chapters Four and Five of this year's edition.

There are other risks associated with saving in and accessing private pensions including (but not limited to):

- Making sub-optimal decisions about how to access retirement savings,[4]
- Poor understanding of the income level required for an adequate standard of living, and the amount that needs to be saved to achieve that income level,
- Excessive product charges (somewhat mitigated by the charge cap on default fund arrangements),
- Poor annuity rates,
- Poorly designed investment strategies,
- Market turbulence,

[3] The Pension Protection Fund protects Defined Benefit scheme members whose sponsoring employer becomes insolvent. For members of Defined Contribution schemes, members can be compensated up to 100% of the value of their pot if their pension provider can't pay members and is authorised by the Financial Conduct Authority (FCA).

[4] This risk has become much greater following the introduction of pension flexibilities. Drawdown investment pathways will help to somewhat mitigate this risk for drawdown customers, but those accessing DC pensions may need further protection in the form of advice, guidance and structured choice architecture. Pension Wise was created in order to mitigate this increased risk by offering a free source of guidance for DC savers.

- Lost pensions (losing track of one or more pension pots),
- Becoming a victim of fraudulent schemes or other pension scams,
- The risk of needs in retirement changing unexpectedly, for example, as a result of developing health and social care needs, and
- The interaction between pension savings and means-tested benefits.[5]

The type of private pension scheme into which people save has implications for the level of risk they face.

Members of DC pension arrangements face more individual risk than members with DB pensions (Box 1.3).

Box 1.3

Defined Contribution schemes: the scheme member bears the investment, inflation and longevity risk. The member bears little of the insolvency risk.

Hybrid, risk-sharing schemes: risk is shared between the employer and employee or between employees. Members bear the insolvency risk. Collective Defined Contribution (CDC) schemes are an example of a risk-sharing scheme.

Defined Benefit schemes: the employer bears the investment, inflation and longevity risks. The member bears the insolvency risk, though there are mitigations.

The impact of these risks will be mitigated for people who have only a small amount of DC savings and have other, larger, sources of income in retirement from, for example, DB pension entitlement. However, for those with very low incomes, small amounts of DC savings may have significant proportional effects on later life living standards if, for example, they can use them to supplement a State Pension income or to pay off mortgages or other debts, which could reduce living costs in later retirement.

The introduction of a third type of pension scheme, Collective Defined Contribution (CDC), presents a new option for risk sharing

The Pension Schemes Act 2021 legislated a framework for the establishment of CDC schemes in the UK, with The Pensions Regulator (TPR) subsequently consulting on a regulatory framework in 2022. CDC schemes have two defining features:

- Collective: Risks and costs are shared collectively between the scheme's members rather than individually.
- Defined Contribution: Contribution rates (employer and employee) are defined in advance, with no ongoing liability to pay more in the future to cover benefits.

[5] Blake & Harrison (2014)

Unlike individual DC schemes, CDC schemes are designed to provide members with an income for life, similar to that provided by DB. However, CDC income levels are not guaranteed and can be subject to increases and decreases during both working life and retirement, depending on the scheme's funding position. CDC could offer a middle ground between DC and DB, providing members with greater certainty about retirement outcomes than is possible in individual DC, while providing greater cost and liability certainty for employers than a DB scheme. However, there are also risks associated with CDC schemes, including the potential for intergenerational unfairness (either real or perceived), member communication challenges, insolvency risk and questions around the scale required to make CDC schemes feasible and effective.

The authorisation and regulatory regime for CDC schemes came into force on 1 August 2022. The Royal Mail has the most advanced plans for the introduction of a CDC scheme and is expected to be the first scheme to receive authorisation.

The pensions landscape has changed over the last few decades as a result of demographic, market, policy and regulatory shifts (Box 1.4-1.7).

Box 1.4: Demographic shifts[6]

Increases in life expectancy and shifts in the old age dependency ratio affect the ability of people to support their own retirements and taxpayers to fund State Pensions and pensioner benefits. Increases in healthy life expectancy affect the length of time people are capable of staying in work before they retire. These shifts provide part of the Government's rationale for rises to State Pension age (SPa), although increases to SPa do not fully reflect increases in life expectancy meaning that SPa changes will not necessarily fully mitigate the increasing cost of state pension provision.

Health expectancy: Babies born between 2016 and 2018 will spend on average 63.1 years (boys) and 63.9 years (girls) in good health, compared to 60.7 (boys) and 62.4 (girls) born in 2002-2004. This means that younger generations should be capable of working longer, on average, than older generations.

Dependency ratio: In 2022 there were 284 people over SPa for every 1,000 people of working age. This is projected to grow to 337 for every 1,000 by 2047.

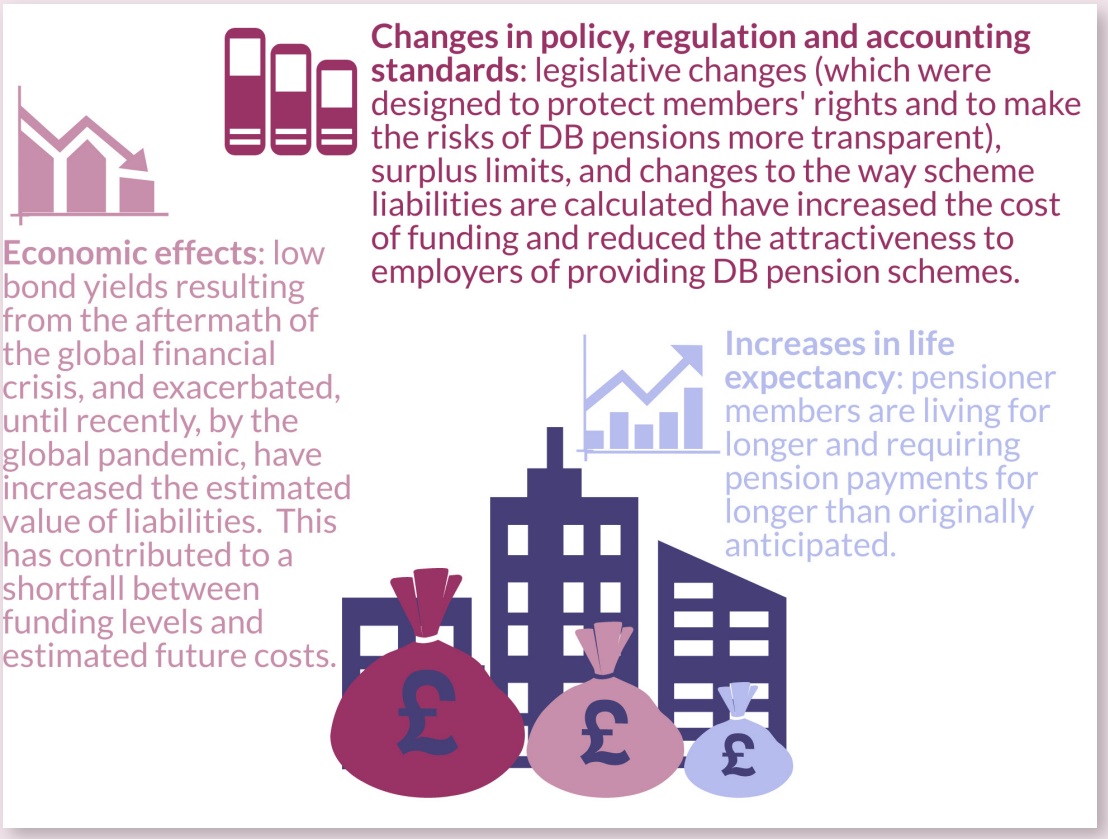
Life expectancy: In 2022, a 65-year-old man can expect to live on average to age 84.9 and a 65-year-old woman to age 87.2. When the contributory State Pension was introduced in 1925, a 65-year-old man could expect to live to around age 76.

[6] DWP (2022a); Office for Health Improvement & Disparities (2022)

Box 1.5: Market changes

DB pension schemes historically dominated private sector pension provision and continue to be the main source of provision within the public sector. Membership of private sector DB schemes peaked in 1967, with around eight million active members.[7] Private sector DB membership has been in decline, especially in recent years. As of 2021, there were around 981,000 active members - falling below one million for the first time. 89% of private sector schemes were closed to new members, but, within that, 39% were open to continued benefit accruals for existing members, while 2% of schemes were in the process of winding up.[8]

Scheme closures can be attributed to several factors, including:



Labour market shifts that have led to fewer people spending most of their working life in a single job may have also diluted the rationale for offering private sector DB schemes. As provision of DB schemes became more challenging for private sector employers, the less risky and less expensive (for employers) DC model became more attractive. As a result of this, and the introduction of automatic enrolment in 2012, the number of active savers in DC schemes has increased rapidly and overtaken the number of active DB savers. In 2022, there are 13.8 million active members in DC schemes, compared to around 981,000 active members in private sector DB schemes.[9]

High levels of DB provision continue within the public sector, with 6.3 million active members. Many public sector DB schemes are funded on a pay-as-you-go basis (with contributions of current active members paying for income payments to current retirees, and the Government making up any shortfall), rather than being backed by assets in the same way that private sector DB schemes are.

There are some exceptions to this among public sector schemes – the Universities Superannuation Scheme (USS), for example.

[7] Carrera *et.al* [PPI] (2012)

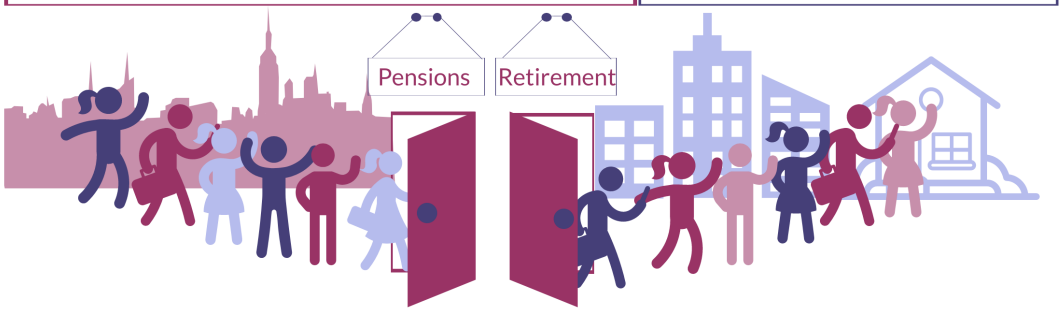
[8] PPF (2021)

[9] PPI Aggregate Model; PPF (2021)

Box 1.6: Policy changes

Automatic enrolment: automatic enrolment requires employers to enrol eligible employees into a qualifying workplace pension scheme. Employees can opt out. For those who stay in, employers are required to make minimum contributions on a band of earnings (£6,240 - £50,270 2022/23). 10.7 million people have been automatically enrolled.

New State Pension (nSP): from April 2016, the basic and additional State Pensions were replaced with a single-tier, flat-rate pension set above Pension Credit (£182.60pw) at £185.15pw for a single person in 2022/23.



Increases to SPa: the SPa rose for women from age 60 in 2010 to age 65 in 2018, then to age 66 for both men and women in 2020. SPa for both men and women will rise to age 67 by 2028 and age 68 by 2039.

Freedom and choice: since April 2015, people have had greater flexibility when they come to access DC pension savings at or after age 55. Prior to these changes, people with DC savings who could not demonstrate a minimum level of secure income were required to use an annuity or capped drawdown in order to access DC savings.

Box 1.7: Regulatory changes

- Value for money: In September 2020, the Government consulted on measures to introduce a more detailed value for member assessment for schemes below £100 million. This was designed to improve governance and better serve members of such schemes, while increasing the pace of consolidation. For the schemes in scope, this means critically assessing various aspects of the scheme to come to a conclusion on whether the scheme currently offers value for members, including comparing themselves against three other schemes. Recognising that the new assessment and subsequent wind-up process will take time, in July 2021, the Government subsequently consulted on how to build on the assessment and further accelerate the pace of consolidation for schemes under £100 million. The consultation also looked ahead to the second phase of consolidation for schemes and how to incentivise consolidation among medium to large schemes with assets between £100 million and £5 billion. The responses to this consultation were mixed. Some stakeholders, supportive of the benefits of greater allocation to illiquid assets, which becomes more accessible with increased scale, expressed the belief that members of smaller schemes were suffering from a limited set of possible investment opportunities as a result of a narrow decision by the scheme's trustees to continue to offer a scheme. Other stakeholders suggested that the proposed benefits of consolidation were in fact overstated, and the costs and risks were poorly understood. Many respondents highlighted the potential for disruption within the market if consolidation is forced

too quickly. The consensus was for the Government to slow down the process to ensure better member outcomes are being achieved. It was recommended that the Department for Work and Pensions (DWP) should wait to see the impact of the new value for member assessments undertaken by small schemes before embarking on new policy ideas that might apply to schemes above £100 million. The Financial Conduct Authority (FCA) and TPR are currently developing a common framework for measuring value for money in DC schemes, with the aim of driving a long-term focus on value for money across the pensions landscape.

- Environmental, Social and Governance (ESG) factors:

Since October 2019, trustees have been required to produce a Statement of Investment Principles (SIP) that sets out: how they take account of financially material considerations, including but not limited to ESG considerations, including climate change; their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with those investments; and the extent to which, if at all, non-financial matters are taken into account in the selection, retention and realisation of investments. From October 2020, these regulations increased further, with trustees of DC schemes with 100 or more members now required to produce an implementation statement explaining how they have followed and acted upon the stated investment policies set out in their SIP. This includes reporting on the way in which the scheme monitors its asset managers who undertake investment and engagement activities on its behalf and whether these managers have acted in accordance with the trustees' stated policies. Since 2021, DB schemes have also been required to publish their SIP alongside a narrower implementation statement covering their engagement and voting behaviour. In December 2019, the FCA introduced similar reporting requirements for contract-based schemes, including a new duty for Independent Governance Committees (IGCs) to consider and report on their firm's policies on ESG issues, member concerns and stewardship. Further regulation has been introduced in line with recommendations from the Task Force on Climate-related Financial Disclosures (TCFD). Since October 2021, DC schemes with more than £5bn AUM, and all master trusts, must produce an annual report specifically on their consideration of climate change risks. From October 2022, this will also apply to DC schemes with AUM between £1bn and £5bn.

- Drawdown investment pathways:

In 2018, the FCA found that around a third of those who have used non-advised drawdown were invested in cash or cash-like assets rather than strategies with the potential for higher returns. The FCA estimated that around half of these savers were likely to experience poorer retirement outcomes as a result of their investment choice. As a result, the FCA has introduced a requirement for drawdown providers to offer "investment pathways" to consumers, who will need to make decisions on how they intend to access their savings and then be given an appropriate underlying investment portfolio on that basis. This process will prevent new drawdown customers being defaulted into all-cash investments.[10] Drawdown investment pathways came into force in February 2021. The FCA has also made it illegal to default consumers into cash drawdown; savers must now actively opt in if they want to invest in cash or cash-like assets.

[10] FCA (2019)

Demographic, market and policy changes affect needs and resources in retirement

The above shifts affect the needs and resources of, and the risks faced by, people at and during retirement. Compared to previous generations, future retirees will:

- Live longer and take their State Pension later,
- Be more likely to reach retirement with DC savings,
- Be more likely to reach retirement with no or low levels of DB entitlement,
- Have near total flexibility in regard to accessing their savings,
- Face more risk and complexity at and during retirement, and
- Be more likely to have a need for long-term care in later life, as they reach older ages, and will face challenging decisions about how to fund this.

Conclusions

There are both benefits and risks associated with saving for a private pension

While saving into a private pension can offer benefits over other savings vehicles (employer contributions, tax relief and compounded investment returns), there are also risks associated with saving into and accessing a private pension (including investment risk, inflation risk, longevity risk and insolvency risk). The level of risk and who it is borne by depends on the type of pension scheme (DB, DC or CDC).

Changes in private pension provision have shifted the balance of risk

As the UK private pensions landscape has shifted rapidly from DB to DC, largely as a result of DB scheme closures and the introduction of automatic enrolment, there has also been a shift of risk from employer to employee.

Changes in private pension provision and the balance of risk mean that retirees are likely to face increased risk and complexity at and during retirement

While some regulation has been introduced to better protect DC savers, there are still challenges. With future retirees likely to live longer and reach retirement with predominantly DC savings, as well as near total flexibility in how they access them, they are likely to face more risk and complexity at and during retirement.

Chapter Two:

What does the DC landscape look like?

Chapter Two: What does the DC landscape look like?

This chapter provides an overall picture of the current Defined Contribution (DC) landscape, including data on automatic enrolment, saving levels, investment strategy, access to savings, and advice and guidance.

Automatic enrolment

Automatic enrolment requires all employers to enrol eligible employees into a qualifying pension scheme. To be eligible for automatic enrolment, an employee must be aged between 22 and State Pension age (SPa) and be earning £10,000pa or above in at least one job. Those who are self-employed or have several jobs which each pay below the £10,000pa threshold are not eligible (even if combined income across multiple jobs totals more than £10,000).

The self-employed group, which includes around 4.1 million people,[11] is excluded from accessing the benefits of automatic enrolment by virtue of the fact that they do not have an employer who can automatically enrol them and contribute on their behalf. Meanwhile, many people with multiple jobs are excluded from automatic enrolment as a result of low earnings. Of the 10.5 million workers ineligible to be automatically enrolled, almost 106,000 workers, of whom 70% are women, are not being automatically enrolled into a pension because their earnings come from more than one job.[12]

Employers are required to contribute on behalf of workers while they remain active members. The minimum required level of aggregate contributions is 8% of band earnings (£6,240 to £50,270 in 2022/23), though employers and workers may choose to contribute more:

- Employers must contribute at least 3% of band earnings on behalf of workers, though employers may choose to cover the whole 8% (with some employers offering pension contributions higher than this).
- Workers whose employer makes only minimum contributions are required to contribute a minimum of 5% of band earnings (though tax relief is applied to contributions, reducing the impact on take-home pay) unless they opt out.

New and newly eligible employees are automatically enrolled and have a one-month window to opt out and receive back all personal contributions. People who cease contributing after the opt-out period has expired are not eligible to claim back their contributions until they reach age 55. Those who opt out or cease contributing are re-enrolled every three years.

Employees and automatic enrolment

Employees were automatically enrolled on a staged basis, starting with the largest employers, in October 2012. By the end of 2018, all existing employers were required to automatically enrol their employees and all new employers after that date have the obligation to automatically enrol their employees with immediate effect.

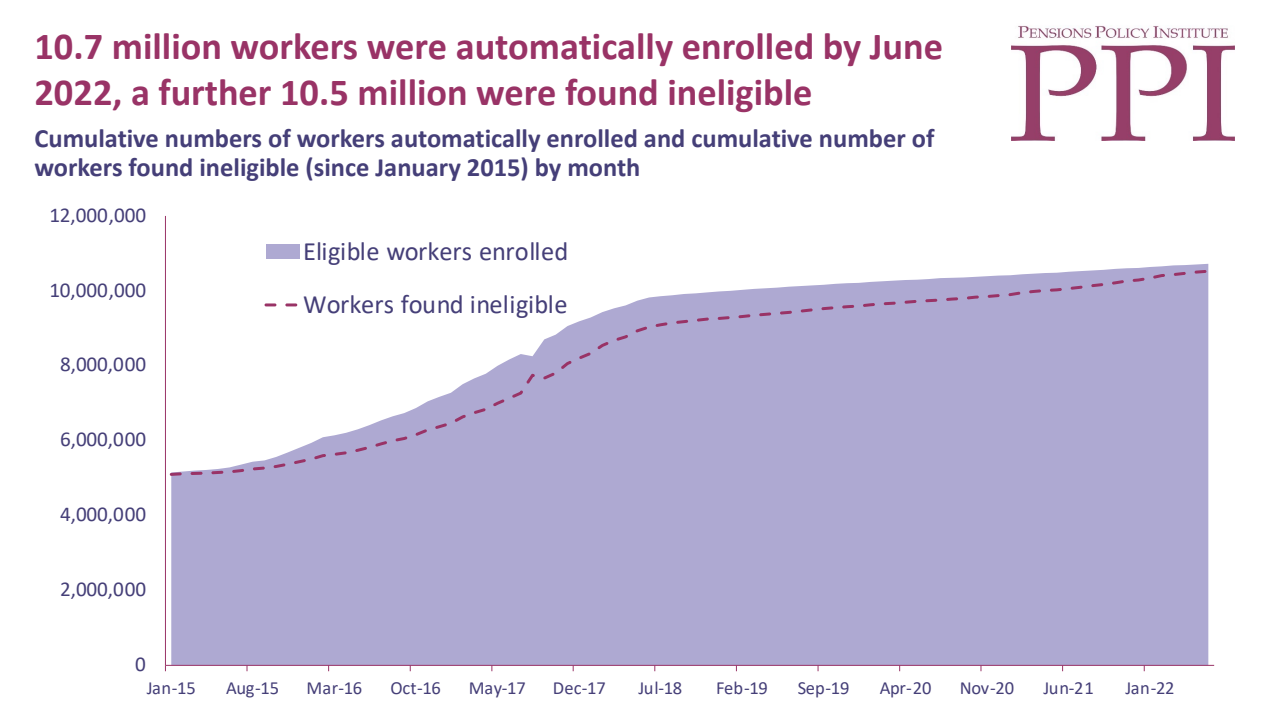
10.7 million people were automatically enrolled by June 2022

By June 2022, 10.7 million employees were automatically enrolled. However, the number of employees found ineligible for automatic enrolment has also continued to grow, reaching 10.5 million by June 2022, compared to 10.1 million at the same time last year (Chart 2.1). The number of employees found ineligible has been growing at a greater rate than those found eligible, which may be a result of an increased number of employees in lower income jobs or more employees working in multiple jobs.

[11] ONS (2022a)

[12] Wilkinson & Jethwa [PPI] (2020)

Chart 2.1[13]



Reducing the age of eligibility for automatic enrolment, from 22 to 18, as recommended by the 2017 Automatic Enrolment Review,[14] could increase eligibility by around 2.8%, while removing the £10,000 earnings eligibility threshold could increase eligibility by around 14% among those in employment – including bringing in many individuals who currently earn £10,000 in total across multiple jobs.[15]

As mentioned earlier in this chapter, people who are self-employed are not eligible for automatic enrolment, by virtue of the fact that they do not have an employer who can automatically enrol them. The National Employment Savings Trust (NEST) has conducted substantial amounts of research and trials on methods of encouraging higher levels of pension saving among the self-employed, following the Automatic Enrolment Review. NEST identified a number of options, with the following found to be most appealing to the self-employed:

- 'Set and forget' mechanisms: 'These captured the idea of saving little and often, but with greater flexibility to irregular and unpredictable incomes this currently possible in retirement saving for most self-employed people. The fact that contributions would only be made in proportion to money coming in, rather than at a fixed, regular amount, had high appeal.'
- Saving at the point when income was known for the year: 'The group liked the simplicity of only having to consider retirement saving once a year. However, a number questioned whether they would be likely to actually get around to contributing in this context or have the funds available at that point when they were also completing their annual tax return.'
- Combining short-term, more liquid savings with retirement saving: 'This was positively received, although it was perceived as potentially complex. Care would have to be taken presenting this approach to self-employed people.'[16]

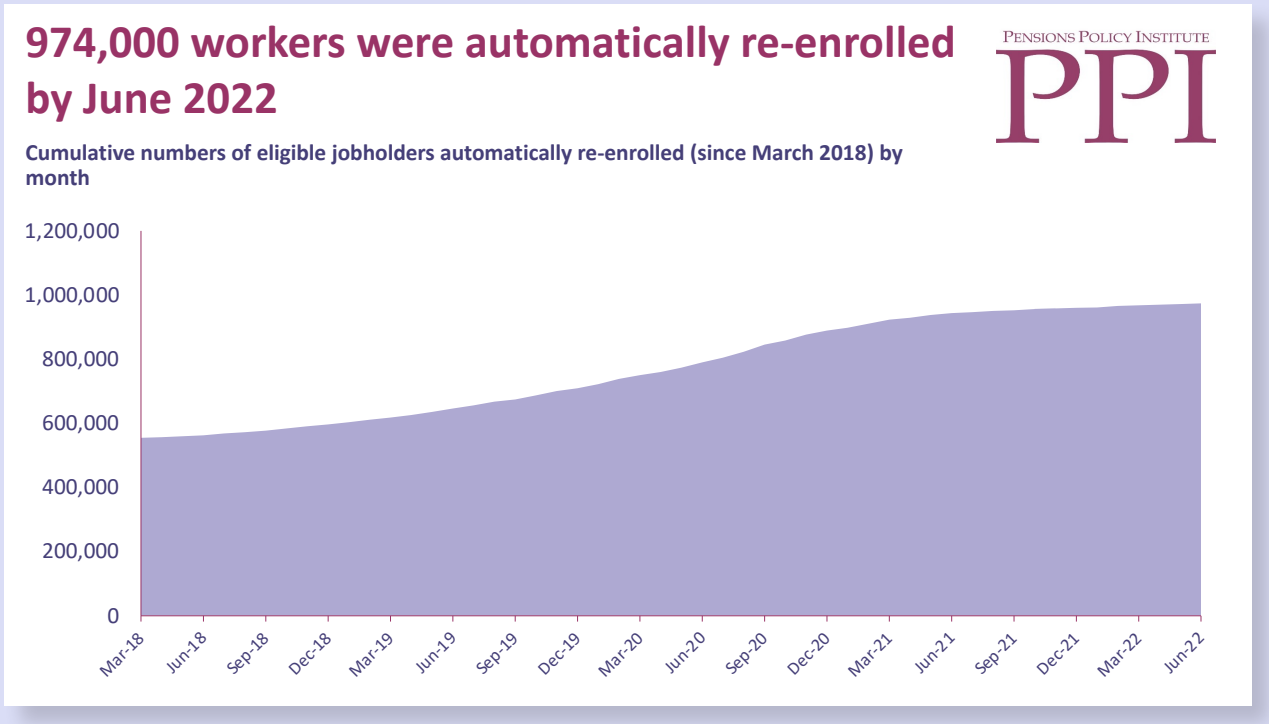
[13] TPR (2021a)
[14] DWP (2017)
[15] PPI analysis of LFS
[16] NEST (2019)

974,000 employees have been automatically re-enrolled

Employers are required to automatically re-enrol all eligible workers every three years. For employees who were already working for the employer at the time of automatic enrolment staging, this means they are re-enrolled three years after the date that they opted out for the first time, and every three years after that if they continue to opt out. For employees who joined the employer after automatic enrolment began, re-enrolment may take place sooner than three years after they first opted out, as re-enrolment is actioned across the full employer at a set date every three years, rather than on an individual employee basis.

As of June 2022, 974,000 employees had been automatically re-enrolled, compared to 944,000 in June 2021 (Chart 2.2).

Chart 2.2[17]



Despite concerns that opt-out rates would increase, they have remained broadly stable

Automatically enrolled employees have the opportunity to opt out and have their contributions returned to them within one calendar month of being automatically enrolled. Prior to the introduction of automatic enrolment, the DWP's impact assessment predicted that around one in three people would opt out.[18] However, over the first 10 years of automatic enrolment, opt-out rates have been consistently lower than this, at around one in 10.[19] As automatic enrolment was gradually rolled out, there were concerns that opt-out rates might increase, either once smaller employers started reaching their staging dates, or as minimum contribution levels increased.[20] However, opt-out rates remained broadly stable throughout staging and contribution increases, as well as through the peak of the COVID-19 pandemic. Some schemes reported increased opt-out rates in the short term – for example, NEST reported that opt-out rates among its members had increased from an average of 8% (since the inception of automatic enrolment) to 11% between April and September 2020, but this has since stabilised at around 10%.[21] The current cost-of-living crisis may cause an increase in opt-out rates in coming months.

[17] TPR (2021a)
[18] DWP (2008)
[19] DWP (2020)
[20] DWP (2020)
[21] NEST (2021)

Automatic enrolment has succeeded in increasing workplace pension participation, particularly in the private sector

In 2012, only 46.5% of employees participated in a workplace pension of any kind. By 2021, workplace pension participation grew to 79.4%. Meanwhile, the gap between workplace pension participation in the public and private sectors has narrowed since the introduction of automatic enrolment. Participation in the public sector increased from a relatively high base of 83% in 2012 to 91% in 2021, while participation in the private sector grew from 32% to 75% over the same period.[22]

While participation in workplace pensions has continued to grow, persistency of saving has declined in recent years – although the reasons for this are unclear

While employees have a one-month period in which they can opt out of their workplace pension and receive back their contributions, some people cease contributing to their scheme after the opt-out period has expired (their contributions remain invested in the scheme). Cessation of saving could be because they:

- leave their current job (they may be automatically enrolled via their next job),
- fall below the eligible earnings band lower limit, or
- do not wish to continue contributing into their automatic enrolment pension scheme.

Because opt-out rates alone do not present the full picture of the proportion of employees that are actively saving into a pension, it is useful to also look at the 'persistence rate' – that is, the proportion of people who have been automatically enrolled and continue to contribute regularly into their pension. In order to measure persistency of saving among the eligible population, the Department for Work and Pensions (DWP) tests the proportion of eligible employees who are contributing into a workplace pension for at least two out of a period of three years. For the most recent available data period, 2017-20, 65% of eligible savers were saving in at least two of the following three years, 1% of eligible savers were not saving persistently, and for the remaining 34% there was indeterminate evidence. While the persistency rate has declined by 13% since 2009-12, when it was 78%, the proportion of eligible savers identified as definitely not saving persistently has remained stable at 1% over this period, with the persistency rate declining as a result of an increase in the 'indeterminate evidence' group. The reasons for this are not clear, however there has been a small decrease in the Annual Survey of Hours and Earnings (ASHE – the data used to determine persistency of saving) response rate since 2014.[23]

Ending an employment is the most common reason for cessation of saving

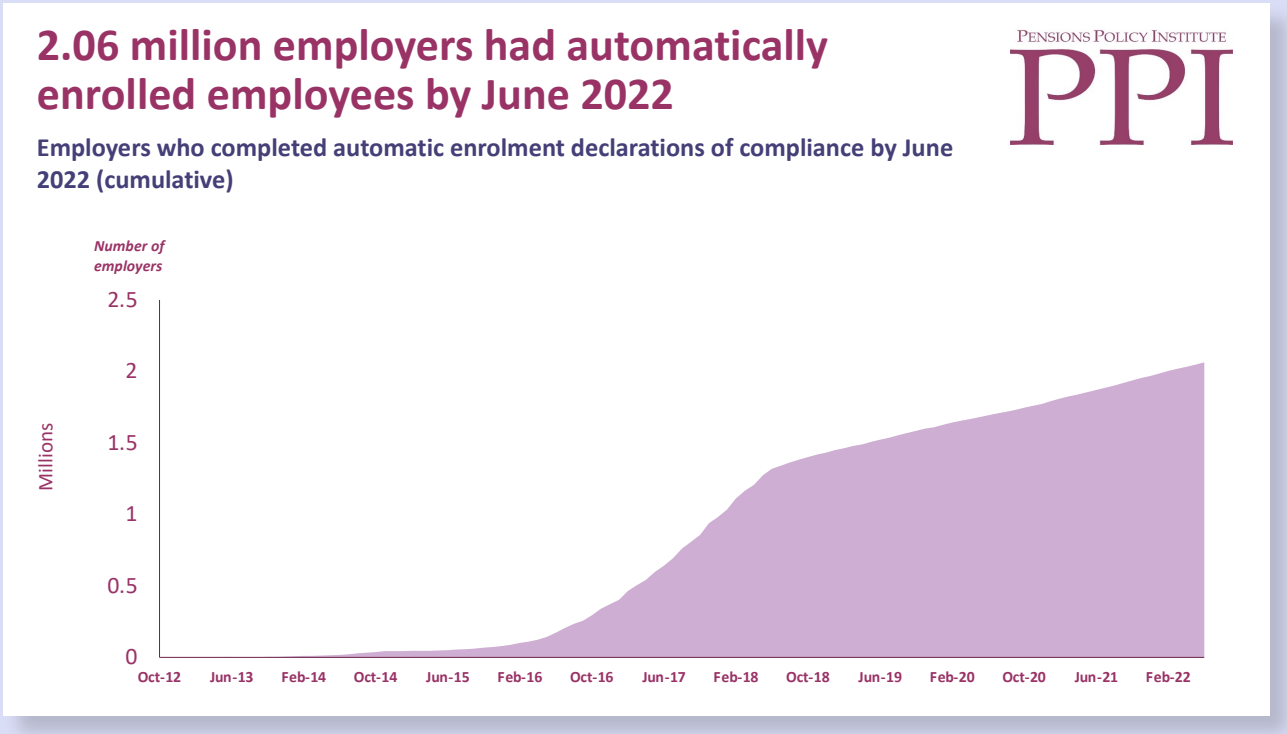
From April 2014 to March 2021, an average of 2.7% of employees stopped making contributions to their workplace pension each month. Within this group, 64% stopped contributing because the employment ended, 11% became ineligible for automatic enrolment (either because of age or, more likely, a reduction in earnings), and 25% stopped contributing as a result of an active decision not to continue saving.[24] Many within the group that stopped contributing as a result of the employment ending will have moved to a new job and been automatically enrolled by their new employer.

[22] ONS (2022b)
[23] DWP (2021)
[24] DWP (2021)

Employers and automatic enrolment

Automatic enrolment is now fully implemented, with all employers having reached their staging date by 2018. All employers are now required to automatically enrol new employees and re-enrol existing employees who have opted out. The number of employers automatically enrolling grew exponentially as smaller employers began to stage in 2014. By the end of automatic enrolment staging, 1.1 million employers had been through the process. By June 2022, this had risen to 2.06 million employers, as a result of new employers joining the market (Chart 2.3).[25]

Chart 2.3[26]



As the number of employers automatically enrolling has increased, so too has the number of compliance and penalty notices issued by The Pensions Regulator (TPR)

The number of employers going through the automatic enrolment process has increased, first as more employers reached their staging dates and subsequently as new employers entered the market. As the number of employers automatically enrolling their employees has grown, the number of compliance and penalty notices (issued by TPR to employers who have not fully complied with their automatic enrolment duties) has also increased. This was not unexpected, given that there are now a greater total number of employers with duties in regard to automatic enrolment. However, penalty notices have increased in proportion as well as number. By the end of 2014, TPR had issued 1,493 penalty notices, representing 3% of the employers who had staged at that time. By the end of 2021, TPR had issued 542,232 penalty notices, representing 28% of employers who have automatically enrolled (Table 2.1).[27] As the issuance of penalty notices as a proportion of total employers continues to grow despite staging having completed, it is worth noting that some employers will have received more than one of these notices, rather than two in five employers having received a notice.

[25] TPR (2022)
[26] TPR (2022)
[27] TPR – compliance and enforcement quarterly bulletins for the relevant periods

Table 2.1 Cumulative number of compliance, contribution and penalty notices issued by time period[28]

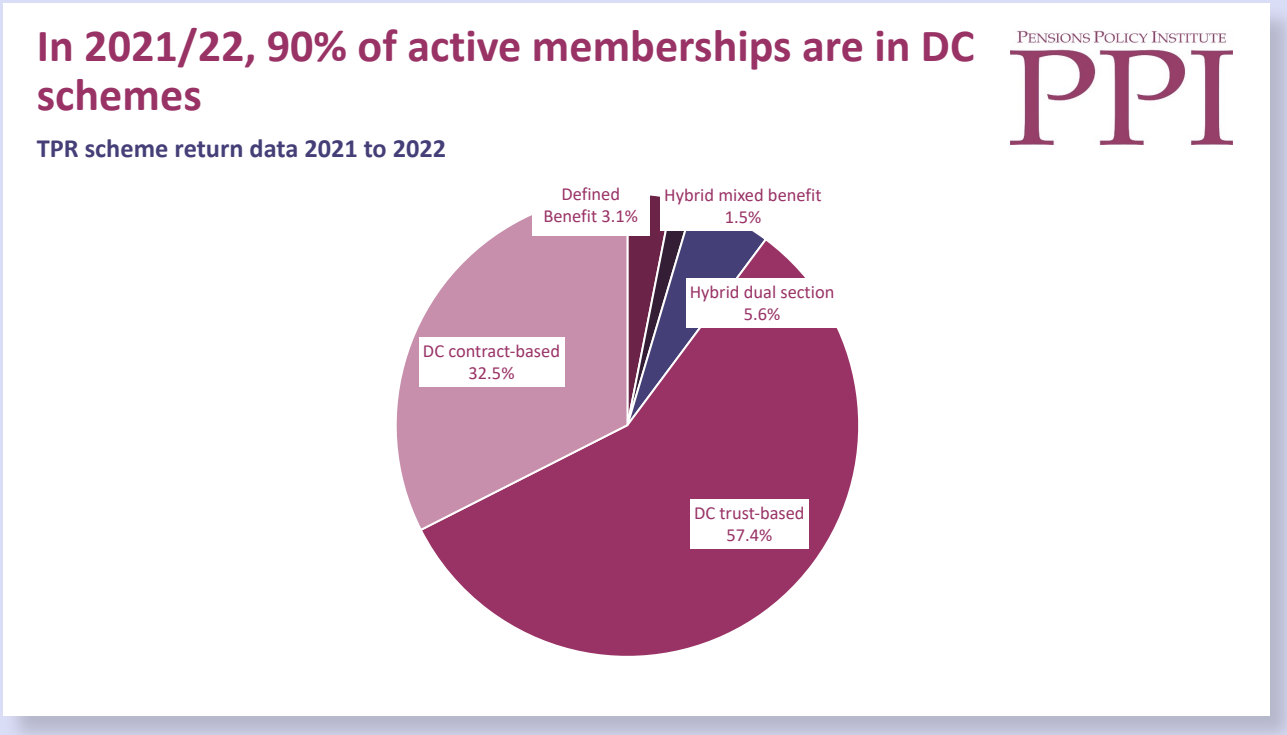
	Total notices	Employers who have automatically enrolled	Proportion of notices to employers
By end 2014	1,493	43,538	3%
By end 2015	6,667	78,789	8%
By end 2016	44,095	370,432	12%
By March 2017	58,817	503,178	12%
By March 2018	157,386	1,166,156	13%
By March 2019	283,730	1,489,815	19%
By March 2020	367,314	1,665,610	22%
By end 2021	542,232	1,967,318	28%

Scheme type

90% of active memberships are now within DC schemes

Employers have a choice about the type of pension scheme they use for automatically enrolling their employees. The provision of Defined Benefit (DB) schemes has dwindled in the private sector (as described in Chapter One), and private sector employers are much more likely to automatically enrol their employees into DC schemes. The use of DC schemes, and especially master trusts, has risen dramatically with automatic enrolment, with 90% of active memberships now in DC schemes (Chart 2.4)

Chart 2.4



[28] TPR – compliance and enforcement quarterly bulletins for the relevant periods

Contributions

The required level of contributions that employers and employees must jointly make into a pension scheme under automatic enrolment legislation (provided the employee hasn't opted out) is currently 8% of band earnings (£6,240 to £50,270 in 2022/23).

Minimum contribution rates required under automatic enrolment are unlikely to deliver adequate retirement outcomes

Under an assumption of full entitlement to the new State Pension (nSP) and a lifetime of minimum required automatic enrolment contributions, anyone earning over £12,700 will require additional savings beyond the default 8% of band earnings to reach their target replacement rate, which will allow them to replicate working-life living standards in retirement. For those on median earnings, the total contribution rate needs to be about 20%, a further 12% above the minimum required under automatic enrolment.

Average employee contributions have stagnated since the most recent increase in minimum rates in 2019

As automatic enrolment was introduced, median employee contribution rates initially fell as a result of more employees joining pension schemes for the first time and paying minimum contributions alongside their employers. This does not, however, mean that those who were already members of workplace pensions prior to the introduction of automatic enrolment began contributing at a lower level, rather that the large numbers of new savers contributing at minimum rates reduced the average contribution level. Average employee contribution rates increased in correlation with increases to minimum required contribution rates in 2018 and 2019. However, since these changes were made, and with no further increases currently planned for minimum contribution rates, average employee contribution rates have stagnated at 4% in trust-based DC schemes and have seen only a very small uplift of 0.1% in Group Personal Pensions (GPPs) (Chart 2.5).

Chart 2.5

Median employee contribution rates in DC schemes have started increasing

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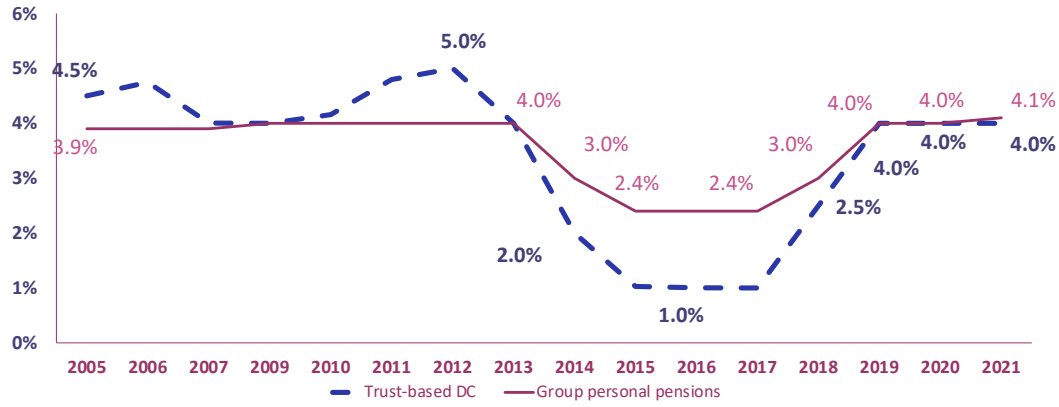
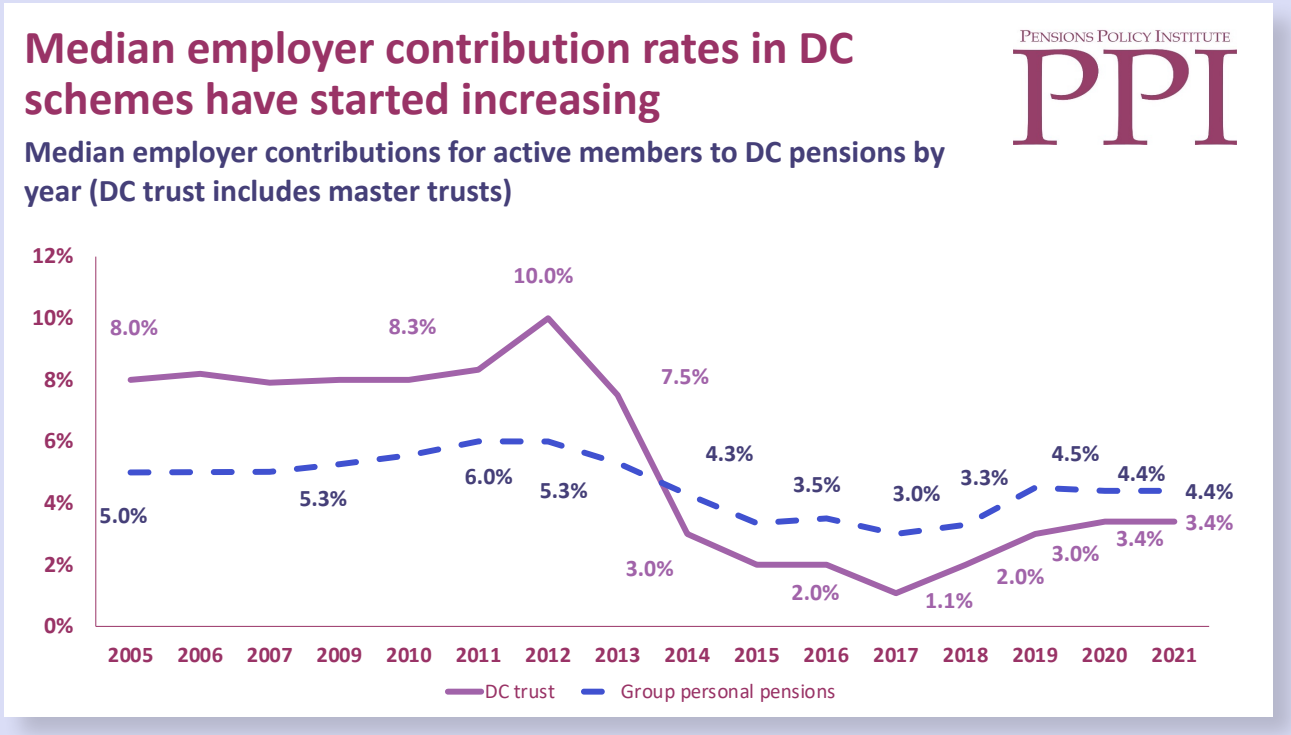
Median active member contribution rates to DC pensions by year (DC trust includes master trusts)



The Automatic Enrolment Review in 2017 recommended lowering the lower earnings band for contributions to £0, so both employees and employers would pay contributions based on the first pound of earnings up to the higher earnings band. The DWP's ambition is to implement this policy in the mid-2020s. If enacted, this change will increase saving levels for those whose employer contributes based on band earnings (some employers choose to contribute based on total rather than band earnings) and would have the greatest proportional impact on lower earners.

Median employer contribution rates have increased as a result of increases in the minimum required rate of contribution in 2018 and 2019. However, like employee contribution rates, average employer contributions have stagnated in the last couple of years (Chart 2.6).

Chart 2.6



Employer contributions may potentially continue to grow in future, especially if the lower level of qualifying earnings is reduced to £0 in accordance with recommendations from the 2017 Automatic Enrolment Review. Now that all scheduled minimum contribution rate increases have been implemented, there have also been recommendations across the industry for further increases to be considered. While past increases to minimum contributions have not resulted in substantial increases in opt-outs, any further increases need to be balanced against the potential risk of encouraging higher opt-out rates. The Association of British Insurers (ABI) have called for default contribution rates to be increased to 12% from 2023, with either an opt-up or opt-down mechanism, meaning that savers can choose to contribute at a lower rate (and potentially receive equivalently lower contributions from their employer) but must make an active decision to do so.[29]

[29] ABI (2022)

DC asset allocation

In addition to contribution rates, the returns produced through scheme investment will also impact DC members' pot sizes at retirement. The next section explores how assets are allocated within DC pension schemes.

Box 2.1: investment strategies

Many asset mixes are labelled as "funds" but consist of several different asset classes which might vary over time. Therefore, it is more accurate to describe asset mixes as "strategies" rather than "funds". Asset mixes might be labelled as, for example, "high-risk", "low-risk", "lifestyle", "with-profits" or "retirement date" strategies, though the structure of each will vary depending on the scheme that is offering it. Most schemes will offer a variety of strategies alongside the default strategy.

The following data is based on responses to the PPI DC Asset Allocation Survey 2022. The participating schemes collectively manage around 24.5 million DC pots, representing a large proportion of the membership of DC workplace pension schemes. Some members covered by the survey will hold multiple pots in several different schemes (Box 2.2)

Box 2.2

PPI DC Assets Allocation Survey 2022 totals

Scheme type	Number of providers	Number of scheme members
Master trust	16	20m
Group personal pension	4	0.2m
Group self invested personal pension	2	3.1m
Personal pension	3	1m
Stakeholder	2	26k
Single employer trust-based	4	0.2m
Totals	6	31	24,526,000

The PPI DC Asset Allocation Survey is an annual online survey that collects data on size, charges and asset allocation across the DC universe. Since its inception in 2015, alongside the first edition of The DC Future Book, the survey has grown from four providers covering around four million members, to 31 schemes covering around 24.5 million members. This year's survey was carried out over June and July 2022. Responses to the DC Asset Allocation Survey have become increasingly concentrated in large master trust schemes, reflecting shifts in the DC landscape.

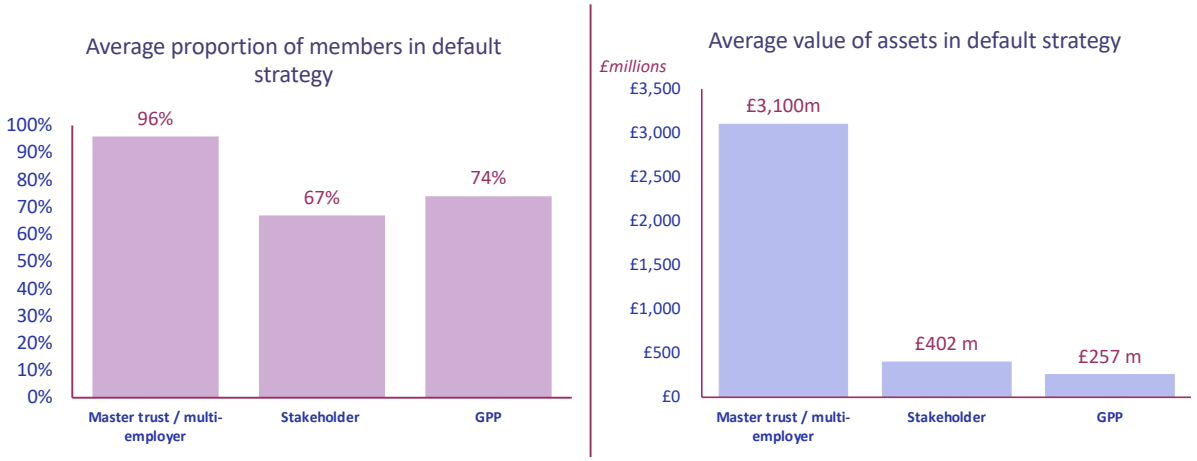
Members of master trusts are more likely to be invested in the default strategy compared to members of single-employer schemes

The vast majority (96%) of master trust members are invested in their scheme's default strategy. Members of smaller master trust schemes, single-employer trust-based schemes, stakeholder and GPP schemes tend to have a smaller proportion of members in the default strategy. Master trusts' default strategies hold the highest value of aggregate assets at £3.1bn on average (Chart 2.7).

Chart 2.7[30]

Members of master trusts are much more likely to be in the default strategy than members of stakeholder and GPP schemes

Average proportion of members and average value of assets in default strategy by scheme type, 2022



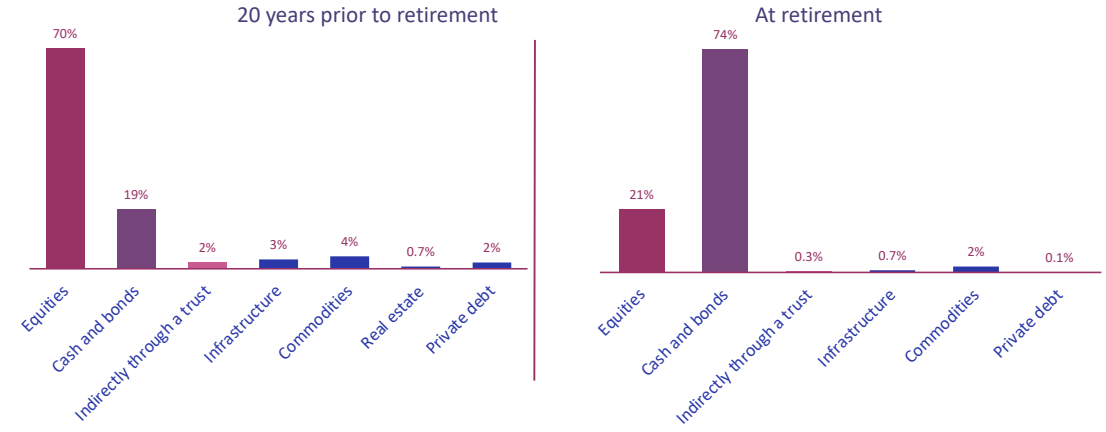
On average, master trust default strategies allocate more than two thirds (70%) of assets to equities 20 years before a member's retirement date (Chart 2.8). Among master trust respondents that were able to provide a more detailed breakdown of the types of equities within which they are invested, 48% of overall assets under management (AUM) were allocated to global developed market equities, 19% to UK equities, and 7% to developing markets.[31]

[30] PPI DC Assets Allocation Survey 2022

[31] These percentages do not total 70% as some respondents provided only total equity allocation, while others provided the total in addition to this more detailed breakdown, meaning that the sample for total equity allocation included additional responses within the average.

Chart 2.8[32]

By a member's retirement date, average allocation to equities in a master trust's default fund has reduced from more than two thirds to less than a quarter



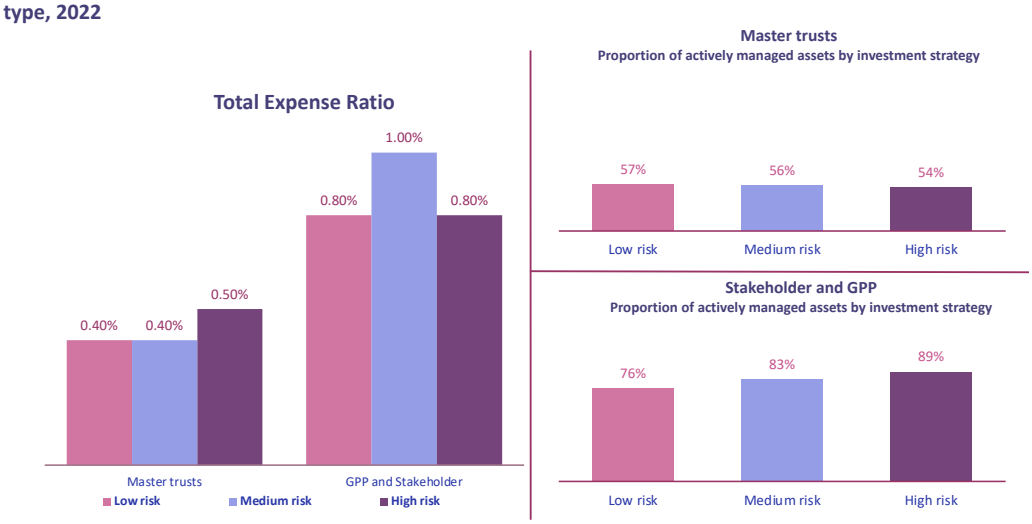
Total Expense Ratios (TERs) tend to be lower in master trust schemes than other DC workplace pensions, due to master trust schemes being designed with economies of scale in mind and some other DC schemes containing older legacy scheme charges on non-default strategies. Master trusts are also more likely to use lower cost funds and asset classes relative to single-employer trust-based schemes. In stakeholder and GPPs, medium-risk strategies tended to have the highest TERs, potentially through greater use of multi-asset funds and non-default strategy funds, though these strategies did not have highest proportions of actively managed assets, with high-risk strategies in GPPs and stakeholder schemes having higher levels (Chart 2.9). There is a low correlation within the survey data between charges and proportion of actively managed assets. Medium-risk strategies in stakeholder and GPP schemes have a higher proportion of actively managed assets than low-risk strategies in these schemes and a considerably higher proportion of actively managed assets than all master trust investment strategies. Within the survey, respondents self-identify what they consider 'active management', so there is likely to be some variation in what is actually meant by this across schemes.

[32] PPI DC Asset Allocation Survey 2022

Chart 2.9[33]

Master trust strategies generally have lower charges and tend to use lower levels of active management

Average Total Expense Ratio (TER) and proportion of actively managed assets by scheme and strategy type, 2022



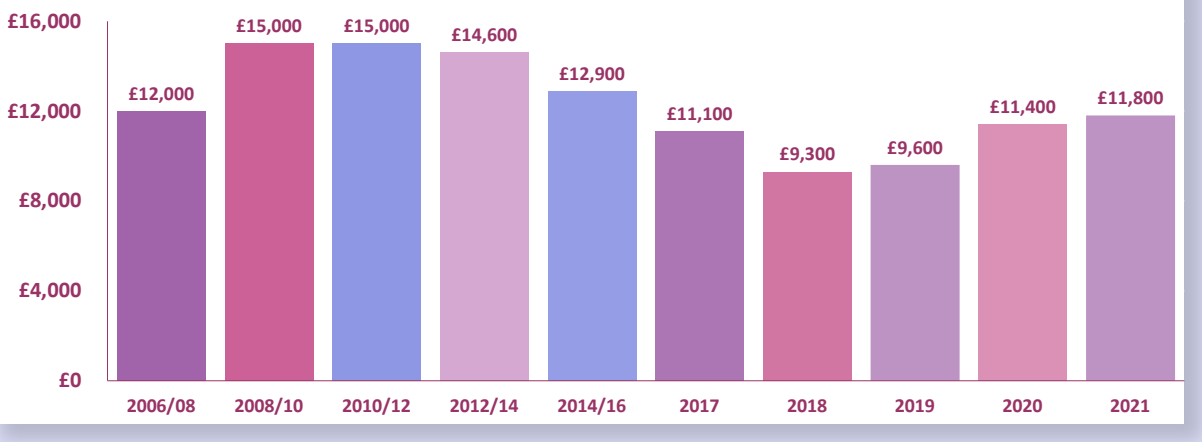
DC saving levels

The introduction of automatic enrolment initially caused the median DC pot size to decrease as millions began contributing to a pension for the first time and accrued initially small pots. Between 2010 and 2018, the median DC pot size decreased from £15,000 to £9,300. However, as a result of the increase in minimum contributions and pots having some time to increase in value, median pot sizes began to increase from 2018 onwards. The rate of growth in median pot size is also increased between 2018-19 (3%) and 2019-20 (19%). However, the rate of increase between 2020 and 2021 returned to levels similar to 2018/19, with average pot size increasing by 3.5%, from £11,400 to £11,800, during this time (Chart 2.10).

Chart 2.10[34]

Median DC pot sizes have started increasing as minimum contributions levels have increased and members have spent a longer time enrolled

Median DC pot size between 2006 and 2021 in UK for people aged 16 and over (includes both deferred and active savers)



[33] PPI DC Asset Allocation Survey 2022

[34] PPI analysis of Wealth and Assets Survey data

Although median DC pot sizes initially declined following the introduction of automatic enrolment, this resulted from an increase in the number of people saving for a pension who had not been saving previously, which skewed the baseline population for analysis. Aggregate assets across all DC savers collectively have increased dramatically since the introduction of automatic enrolment. For example, between 2015 and 2022, aggregate assets in DC grew from £324 billion to £545 billion. The strong investment returns from certain asset classes, such as equities, from 2009 to 2021, excepting the disruption to financial markets in the early stages of the pandemic in 2020, would also have been a contributory factor to the growth of DC assets.

Deferred members

Automatic enrolment has increased the number of small, deferred pension pots, leading to concerns about how this may undermine progress on adequacy targets. Member charges often erode small, deferred pots over time, and small pots can be uneconomic for providers to manage. These extra management costs may eventually be passed on to members through increased charges. It is estimated that there are:

- More than three million deferred savers invested in schemes' default strategies, with pot sizes of under £100;
- A total of 10.5 million deferred savers with pot sizes under £1,000; and
- There could be as many as 27 million deferred pots by 2035 if no measures are taken to consolidate pots. [35]

Policies aimed at consolidating pots are likely to provide a better long-term solution than tackling charging structures. Altering charging structures is unlikely to resolve the problems associated with small, deferred member pots, as charges either erode member pots or prevent schemes from breaking even on pot management, and deferred pots will not generally grow large enough to overcome these issues. That is unless the member reactivates their contributions, if eligible to do so, or consolidates this pot with other pots.

If DC pension pots are to remain financially sustainable for both members and providers, a more strategic policy-based approach, exploring options for pot consolidation is required. The Government is currently considering ways of dealing with the challenge presented by small, deferred pots, with the Small Pots Working Group publishing a report setting out potential options in 2020. The Small Pots Co-ordination Group has been subsequently set up to further explore potential solutions. This is an industry group, jointly convened by the ABI and the Pensions and Lifetime Savings Association (PLSA), including experts from the DWP, a range of pension providers, industry, regulatory and consumer bodies. The Group has recommended three potential solutions to be taken forward:

- The Pot Follows Member model: When a saver moves jobs, their pension pot automatically moves with them from their former employer's scheme to their new employer's scheme, with the opportunity to opt out if they would prefer their pots to remain separate.
- The Default Consolidators model: Multiple deferred small pots belonging to a single saver are automatically transferred to a small pot consolidator, with the opportunity to opt out.
- The Member Exchange model: Small deferred pots within master trusts are automatically consolidated with the saver's active pot within a different master trust.[36]

[35] PLSA (2021) Small pots cross-industry co-ordination group: Initial update report; Baker, M. et al. (PPI) (2020) Policy options for tackling the growing number of deferred members with small pots
[36] Small Pots Cross Industry Co-ordination Group (2022) Spring 2022 Report

Accessing DC savings in retirement

The data on access to savings in this report uses information provided by ABI members and therefore does not cover the full market. However, the data provides a picture of the overall trends in accessing DC savings.

Annuities

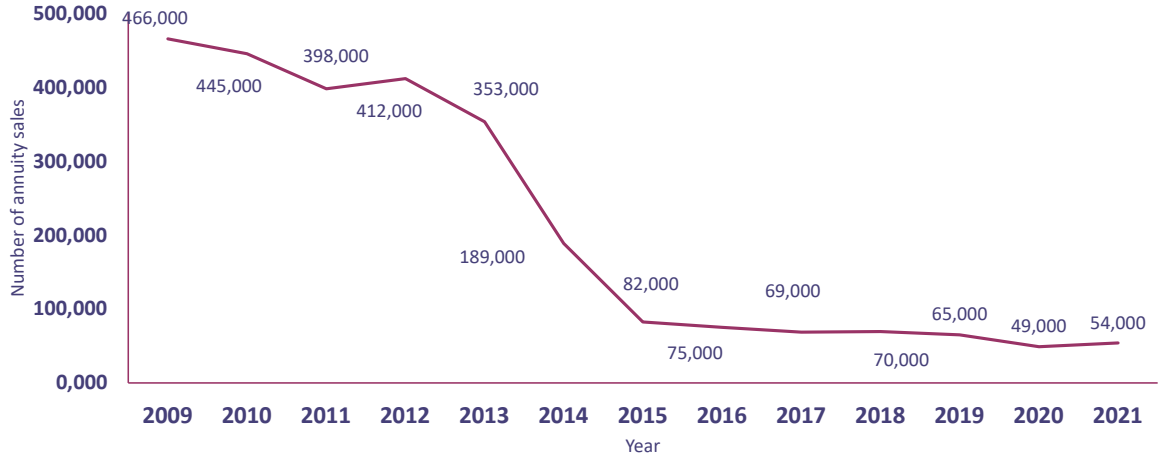
Prior to the introduction of the new pension flexibilities in 2015, the majority of people used their DC savings to purchase an annuity; this was the main option available to many savers, due to regulations around how savings could be accessed at the time. In 2012, over 90% of DC assets being accessed were used to purchase annuities. Overall sales of annuities peaked in 2009 at around 466,000.[37] However, since then, they have been declining.

When pension freedoms were introduced, annuity sales declined more rapidly, and have averaged around 70,000 per year throughout 2016 to 2019. However, 2020 saw a much sharper decline in annuity sales, with just 49,000 sold over the course of the year, potentially as a result of the pandemic increasing annuity prices and so making annuities less attractive, and/or people delaying retirement because of the pandemic's effect on their savings. In 2021, annuity sales increased by 10% but remained much lower than pre-pandemic levels, at 54,000 (Chart 2.11).

Chart 2.11[38]

Annuity sales increased by 10% in 2021, but remained well below pre-pandemic levels

Number of annuities sold by ABI members by year, 2009-2021



The lower-than-average level of annuity sales in 2021 are likely attributable to the ongoing impact of the pandemic. It is unclear how long this trend towards lower annuitisation will continue and at what level annual annuity sales will stabilise during the recovery period. In 2022, with rising bond yields, annuity pricing is starting to become more attractive and could lead to annuitisation returning to pre-pandemic levels.

[37] ABI (2015)
[38] ABI data

Income drawdown

The use of income drawdown was fairly consistent between 2010 and 2014, with around 20,000 new contracts being purchased each year. In 2014, after the announcement of pension flexibilities, the number of drawdown sales doubled to almost 40,000 new contracts. Since then, it has been steadily increasing, growing to around 116,000 new contracts being sold in 2019. However, in 2020, drawdown sales declined to 94,000. As with the decline in annuity sales, this was likely linked to the pandemic and associated volatility in investment markets. Annual drawdown sales remained relatively stable into 2021, declining slightly to 93,000 (Chart 2.12). Around 57% of drawdown sales were internal (remaining with the same provider as had managed the pot during the accumulation phase), while 43% of sales were external, with the pot moving to a different provider. [39]

Chart 2.12[40]

In 2021, around 93,000 drawdown contracts were purchased, with an aggregate value of £7.8 billion invested

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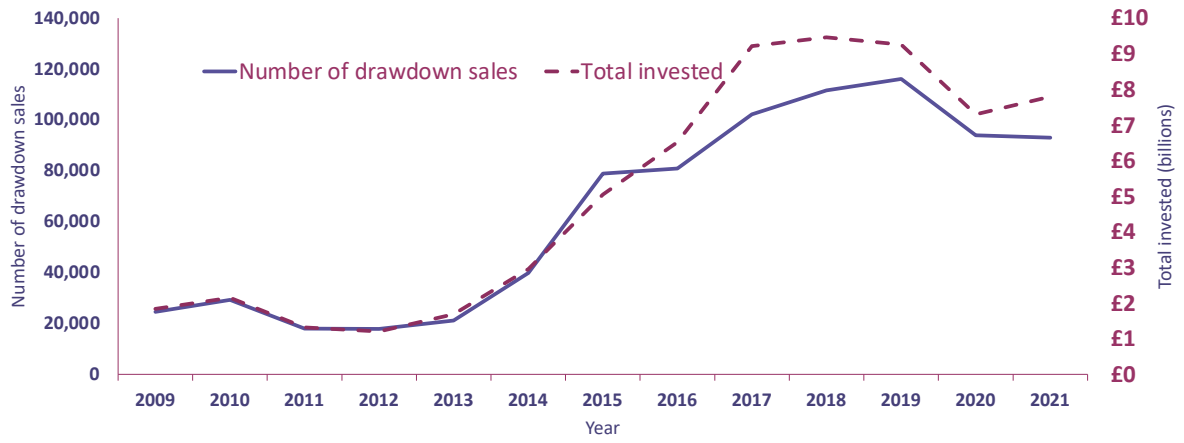
Number of new sales of drawdown contracts and value of sales by year, among ABI members, 2009-2021



While the number of drawdown sales was lower than 2020, the amount invested increased by around £0.5billion. This increase in aggregate assets invested in drawdown in 2021 compared to the previous year is likely to be linked, at least partially, to the recovery from the extreme volatility and market downturns that negatively impacted DC investment returns in 2020.

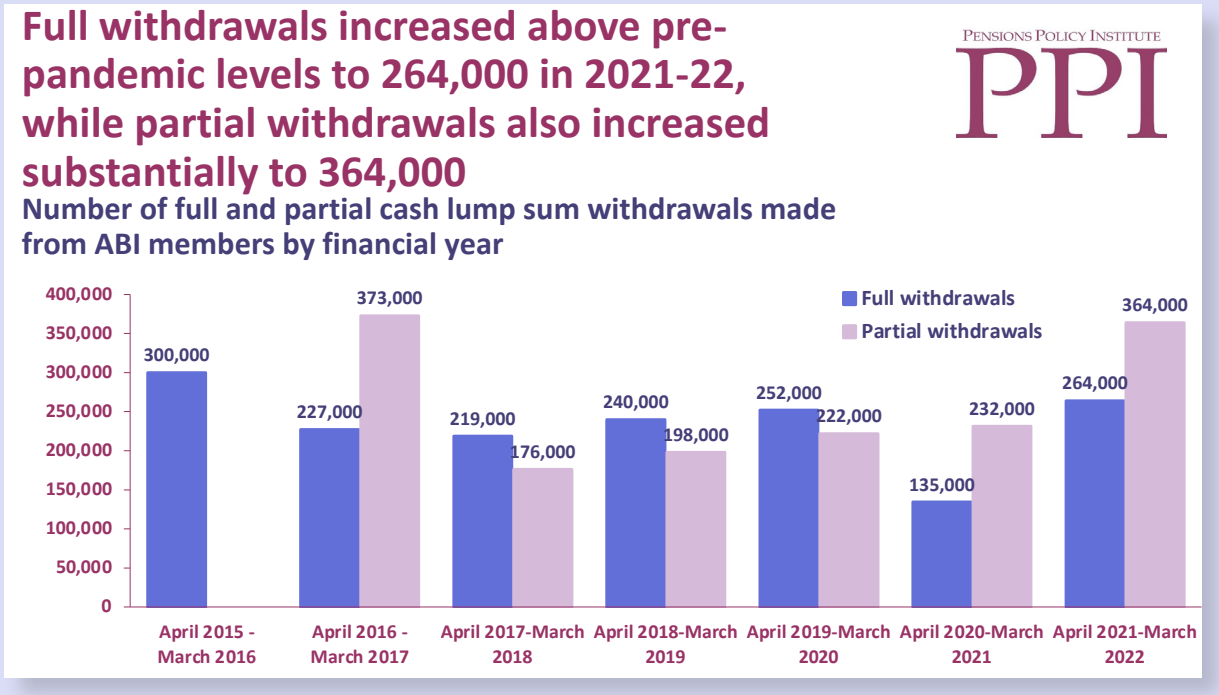
DC savers taking out annuity or drawdown contracts tend to do so using larger funds than those taking lump sum withdrawals. In 2021, the average fund used to enter drawdown was £114,000 and the average fund used to purchase an annuity was £70,000.

[39] ABI data
[40] ABI data

Lump sums

Since April 2015, those aged 55 and over can withdraw partial or full cash lump sums from their DC savings. Withdrawals are taxed at the individual's highest marginal rate of income tax, with 25% tax free.[41] The number of full (total pot) lump sum withdrawals was initially high at 300,000 in the financial year 2015/16, due to pent up demand, but decreased to around 252,000 in 2019/20. As with other means of accessing DC pots, full lump sum withdrawals declined in 2020/21, to 134,500, while partial withdrawals increased to 232,000. In 2021/22, full withdrawals increased above pre-pandemic levels to 264,000, while partial withdrawals also increased substantially to 364,000 (Chart 2.13).[42] This increase is likely to be the result of a combination of factors, including pent up demand, as many savers held off from accessing their pots during the uncertainty of the pandemic, as well as cost-of-living pressures causing people to access their pension pots in higher numbers.

Chart 2.13[43]



There is still a reasonable amount of variation in the number of withdrawals taken each year and so it is not yet clear what the overall trend might be over the longer term. This has been further exacerbated by the unpredictability and volatility brought on by the pandemic, which is likely to extend the time before we can make definitive statements about long-term trends in withdrawals.

DB transfers

While pension freedoms apply to DC rather than DB, members of DB schemes are allowed to transfer out of DB and into DC, with their entitlement converted into a Cash Equivalent Transfer Value. Increased flexibility, falls in interest rates leading to increased transfer values, and bad press associated with some DB schemes[44] have incentivised some people to transfer their DB entitlement into a DC scheme, in order to be able to access their pension savings flexibly and feel a greater sense of ownership over their pension savings. While transferring may benefit some people, there are two main risks associated with transfers from DB to DC:

[41] Prior to April 2015, only those with DC pots under £15,000 (increased to £18,000 in 2015) could withdraw their entire fund as a lump sum without incurring a tax penalty.
[42] ABI data
[43] ABI data
[44] XPS Pensions Group (2019)

- Individual risk: If people transfer out of a DB scheme when it is not in their best financial interest to transfer.
- Scheme risk: Where substantial transfers out of DB schemes could cause schemes to change or review their investment strategies. However, in some cases, transfers out could help scheme funding through the reduction of ongoing liabilities.

While DB transfers increased following the introduction of pension flexibilities, they have since begun to decline

Over six million people are eligible to transfer deferred benefits from a DB scheme, but those transferring a DB entitlement worth £30,000 or more are required to take regulated advice before doing so. Between October 2018 and March 2020, around 52,400 DB pension savers transferred their DB pension out of the scheme after receiving advice, including some who were advised not to transfer:

- Around 87,500 people sought advice regarding whether to transfer
- 57% (49,500) of those seeking advice were advised to do so
- Of the 43% (38,000) who were advised not to transfer, 8% (2,900) still chose to transfer out of the scheme, known as "insistent clients"[45]

Because of the risks associated with accessing DC savings, increased numbers of DB transfers raised concerns that some savers could experience poorer retirement outcomes as a result. The Financial Conduct Authority (FCA) has increased guidance for those advising on DB transfers in order to support better retirement outcomes.

Advice and Guidance

Because of the complexity of decisions about how to access DC savings, people may need to access guidance and/or advice to support them in making choices to achieve positive retirement outcomes.

Box 2.3: What is the difference between advice and guidance?

Advice and guidance are subject to different regulatory requirements. The Financial Advice Working Group (FAWG), established by the FCA, developed the following explanations through consumer research:

Guidance or information

- 'Guidance is an impartial service which will help you to identify your options and narrow down your choices, but will not tell you what to do or which product to buy; the decision is yours.
- Providers of guidance are responsible for the accuracy and quality of the information they provide, but not for any decision you make based on it.
- Guidance is free, unless your provider clearly tells you otherwise.
- It will suggest what you could do.'[46]

Advice

- 'Advice will recommend a specific product or course of action for you to take given your circumstances and financial goals. This will be personal to you, based on information you provide.
- Advice will be provided by a qualified and regulated individual, or online by a regulated organisation.
- Providers of advice are responsible and liable for the accuracy, quality and suitability of the recommendation that they make, and you are protected by law.

[44] XPS Pensions Group (2019)
[45] FCA (2021b)
[46] Financial Advice Working Group (2017)

- You will usually pay a fee for advice. Fees will be disclosed before you are asked to commit yourself.
- It will recommend what you should do.'[47]

A greater cost is generally attached to the provision of independent (or restricted) advice, in return for the adviser or firm taking on some of the responsibility for the outcome of acting on the advice offered. The use of guidance puts responsibility for the financial decision making on the consumer, who also bears the risks of making a bad decision. Some financial transactions, such as purchasing drawdown products or transferring DB entitlement into a DC scheme, will particularly benefit from independent financial advice.

The introduction of new pension flexibilities in 2015 has impacted the market for advice and guidance in a variety of ways:

- Some people who previously would have bought an annuity will choose to access pension savings through other means, such as drawdown. Some of these people may use advisers at and during retirement to help manage more flexible access methods.
- DC pension scheme members are now eligible for £500 of tax-free employer-arranged advice, if their employer chooses to provide this, and may take £500 from their pension pots up to three times to pay for advice. However, not all employers offer this.
- Some organisations offer web-based "robo-advice", which is aimed at people who would benefit from advice but may not have access because they cannot afford, or believe they cannot afford, regulated financial advice. Robo-advice uses algorithms to help answer money-based questions and should allow advice to be offered more quickly and cheaply.
- The introduction of pension flexibilities was accompanied by a new, national guidance service known as "Pension Wise". Pension Wise offers free independent guidance (online, by telephone or face-to-face) to those aged 50 or above with DC savings (Box 2.4). Pension Wise has since merged with two other guidance providers, The Pensions Advisory Service and the Money Advice Service, to form a single guidance body, the Money and Pensions Service, which provides guidance on pensions and other financial issues.

Box 2.4: Figures for Pension Wise[48]

During the 2021/22 financial year:

- Face-to-face appointments remained unavailable (due to the ongoing pandemic); they were also unavailable in 2020/21, while there were 95,000 in 2019/20.
- There were around 152,800 telephone appointments arranged, compared to 114,000 in 2020/21 and 68,000 in 2019/20, with this significant uplift likely due to the suspension of face-to-face appointments.
- There were 59,100 self-serve journeys completed via the Pension Wise website, compared to 47,800 in 2020/21.

[47] Financial Advice Working Group (2017)
[48] https://maps.org.uk/moneyhelper-pension-take-up-dashboard/

New regulations came into force from 1st June 2022 that require pension providers to give members accessing their pension pots a 'stronger nudge' towards Pension Wise's guidance services, including offering to book a Pension Wise appointment on the member's behalf.[49] Aiming to increase the use of guidance, this regulation may increase the number of Pension Wise appointments in coming years.

Fewer people are using regulated advice when purchasing retirement income products

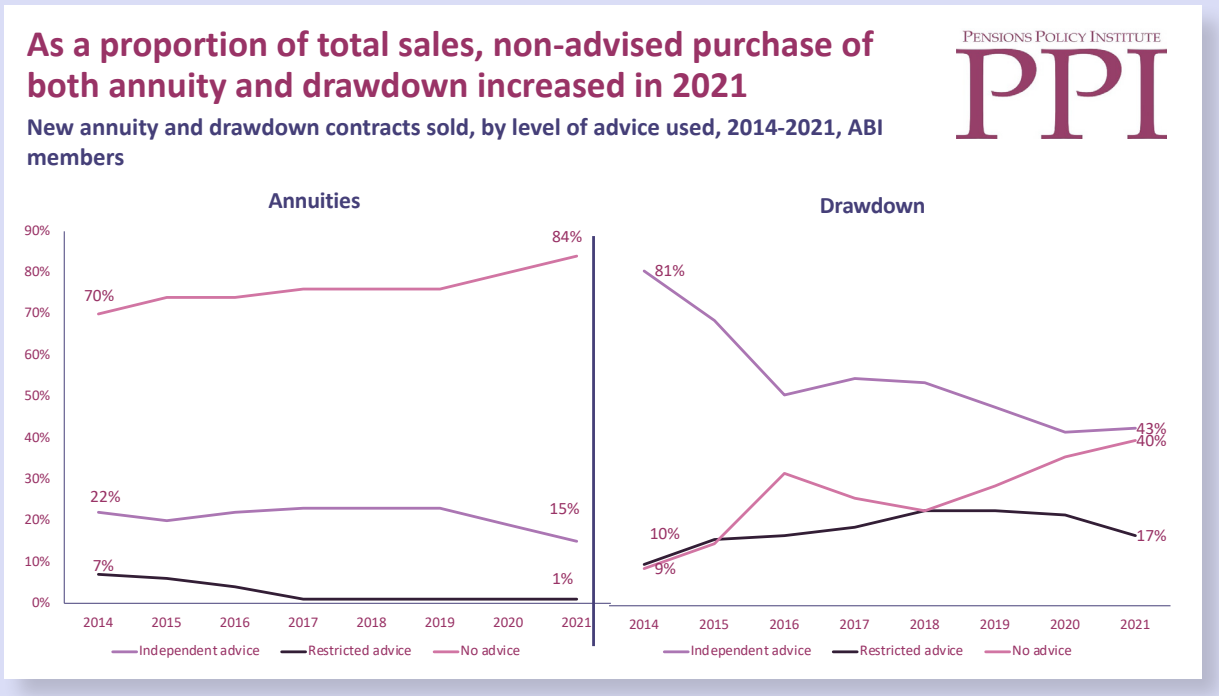
The use of regulated advice for those purchasing drawdown has decreased since 2014. It increased slightly in 2017 and 2018, but has subsequently declined again in the years that have followed:

- In 2021, 43% of those purchasing drawdown products from ABI members used independent advice, a slight increase on 2020 (42%) but still a significant decline compared to 48% in 2019.
- The proportion of drawdown purchases using restricted advice rose between 2014, when it was 10%, and 2019, when it reached 23%. In 2020, the proportion using restricted advice declined slightly to 22%, with a more significant decline in 2021 to 17%.
- 40% of new drawdown contracts in 2021 were purchased without any advice being taken (Chart 2.16).

The use of regulated advice for those purchasing an annuity remained relatively stable following the introduction of pension flexibilities in 2015, but has decreased over the last two years:

- The use of independent advice for annuity purchases decreased to 15% in 2021.
- The use of restricted advice for annuity purchases has remained stable at around 1% for the last five years.
- In 2021, 84% of annuities were purchased without taking any regulated advice (Chart 2.16).

Chart 2.16[50]



Purchasing retirement income products without the use of advice or guidance increases the risk that individuals will not make optimal decisions for meeting their income needs in retirement.

[49] DWP (2022b)
[50] ABI data

Conclusions

By June 2022, 10.7 million employees were automatically enrolled, slightly more than the 10.5 million employees who have been found ineligible due to age or earnings. To June 2022, 974,000 employees have been automatically re-enrolled after previously opting out. Opt-out rates remain stable at around one in 10, although there was some evidence of increased opt-out rates in the short term during the peak of the pandemic. While participation in workplace pensions has continued to grow, persistency of saving has declined in recent years, although the reasons for this are unclear.

While average DC pot sizes declined in the early years of automatic enrolment, they started to increase between 2018 and 2019, from £9,300 to £9,600, as minimum contribution levels have increased and members have spent a longer time enrolled. The median DC pot size increased to £11,400 in 2020, while in 2021, this increased by only 3.5% to £11,800.

Drawdown and annuity sales remained relatively stable in 2021 compared to 2020, but were still significantly below pre-pandemic levels

Chapter Three:

How might the DC landscape evolve in the future?

Chapter Three: How might the DC landscape evolve in the future?

This Chapter uses PPI modelling to explore how the Defined Contribution (DC) landscape might evolve in the future both for individuals and on an aggregate level.

The evolution of the DC market depends on many factors

Previous chapters have set out the current state of the DC market and outlined the factors which are likely to lead to changes in the future, including:

- Automatic enrolment
- The shift from Defined Benefit (DB) to DC pension provision in the private sector
- The introduction and use of pension flexibilities
- Changes to the way that advice and guidance are used and delivered

The way that the DC market evolves in the future will also depend on how individuals respond to policies such as automatic enrolment and pension flexibilities, as well as external factors such as employer behaviour and the performance of the overall economy.

Box 3.1: Explanation of the modelling

This report uses the PPI suite of models and data from the Office for National Statistics' (ONS) Wealth and Assets Survey (Wave 6) to explore how DC assets may change and grow in the future under the assumption that current trends continue. The Chapter also sets out the potential distribution of DC assets, under a range of possible future economic scenarios (based on historical data).

The future value of DC assets depends on many variables:

- Employee behaviour - participation and contribution levels.
- Employer behaviour – contribution levels, scheme choice, remuneration decisions.
- Industry behaviour – charges, investment strategies, default offerings, new scheme development (e.g. Collective Defined Contribution schemes).
- Economic, demographic and financial market effects – market performance, inflation, age and size of the working population.
- Policy changes – taxation, changes to minimum pension age, introduction of new scheme-types, or a policy of auto-escalation of contributions under automatic enrolment.

The model outputs should be viewed as an illustration of a range of potential scenarios arising from current trends, and not a prediction of the future.

The following analysis explores how a continuation of current trends in DC saving could affect the membership numbers and the aggregate value of DC scheme assets in the future.

How might scheme membership develop in the future?

Under automatic enrolment, employers could choose to use their existing workplace pension provision as long as it qualified under the automatic enrolment regulations. Those without existing provision, or who wished to change their offering for new or existing members, had the choice to set up and run a DB, DC or Hybrid/risk-sharing scheme themselves, or to offer membership in a DC scheme run by a third-party. Some employers offer a combination of these.

Box 3.2: Assumptions

The following analysis is based on the assumptions that:

- All eligible workers are automatically enrolled and 15% opt out or cease contributing after the opt-out period has expired, before accruing meaningful amounts of assets.
- Of newly enrolled workers:
  - 80% are enrolled into a master trust scheme.
  - 20% are enrolled into a non-master trust, automatic enrolment DC scheme.[51]

The displacement of members, leaving one type of scheme and entering another (as a result of movements in and out of the labour market or between jobs) results in roughly the same proportions of the workforce in different types of schemes. New members of DC schemes, who may be leaving DB schemes or be newly automatically enrolled, are split in the proportions outlined above between automatic enrolment and workplace DC schemes which pre-dated automatic enrolment.

By 2042, there could be 10.6 million people actively saving in master trust schemes, and 15 million active DC savers overall

In 2022, there are around 13.8 million active members in DC workplace pension schemes. Around 8.9 million of these are in master trusts, around 2.7 million are in DC schemes which existed prior to automatic enrolment, and around 2.2 million are in new DC schemes created subsequent to automatic enrolment (but which are not master trusts).[52]

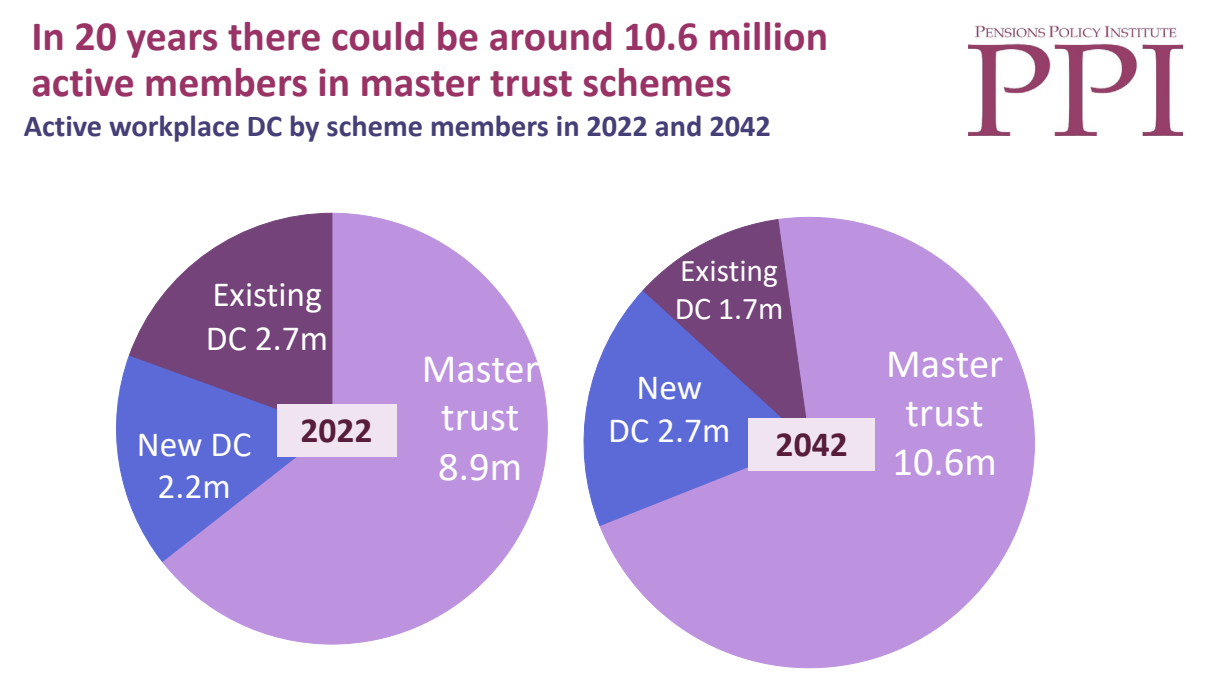
Assuming current trends in scheme allocation continue, by 2042 there could be around 15 million active members in DC workplace pension schemes, with around:

- 10.6 million in master trust schemes,
- 1.7 million in DC schemes which pre-dated automatic enrolment, and
- 2.7 million active members in other automatic enrolment DC schemes (Chart 3.1).[53]

The number of active members in private sector DB schemes could shrink from 981,000 in 2021 to 400,000 by 2041.[54]

[51] Based on information about scheme allocation from The Pensions Regulator – does not account for opt-ins or ineligible workers who are automatically enrolled.
[52] PPI Aggregate Model
[53] PPI Aggregate Model
[54] PPI Aggregate Model

Chart 3.1[55]



Box 3.3: Assumptions

The following analysis is based on the assumptions that:

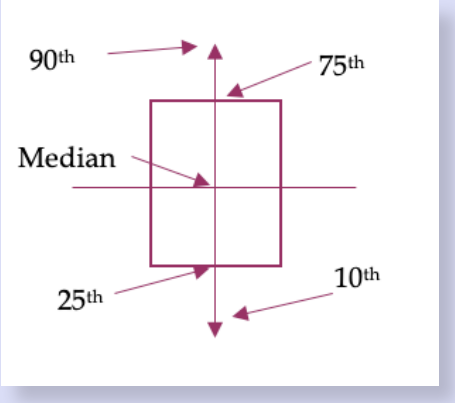
- Those currently saving into a workplace DC pension (trust- or contract-based) continue saving at their current level and continue contributing, with their employer, in the same proportions.
- Those who are not currently saving, but are eligible, are automatically enrolled and do not opt out.[56]
- Before charges, investments yield a nominal average annual investment return of 6%.[57]
- Earnings increase by 3.4% on average per year over the course of the projection.[58]
- Annual Management Charges (AMCs) range between 0.5% and 0.75% depending on scheme type.

Economic assumptions are based on Office for Budget Responsibility (OBR) projections appropriate to the projection period.[59]

[55] PPI Aggregate Model
[56] It is expected that a proportion of people will opt out of automatic enrolment; reasons for doing so are specific to each person and difficult to predict. While the aggregate modelling approach allows us to make a blanket assumption across the population, the modelling presented in this section is based on analysis of individuals making it difficult to accurately predict who would and who would not opt out. The modelling instead presents the potential savings under the current automatic enrolment system.
[57] A blend of Office for Budget Responsibility (OBR) returns based on an asset mix to represent typical pension portfolios. The long-term economic assumptions are based on the OBR Fiscal Sustainability Report (July 2020)[58] See the appendix for further detai on assumptions
[58] Based on OBR projections from Fiscal Sustainability Report
[59] See the appendix for further detail on assumptions

Chart 3.4

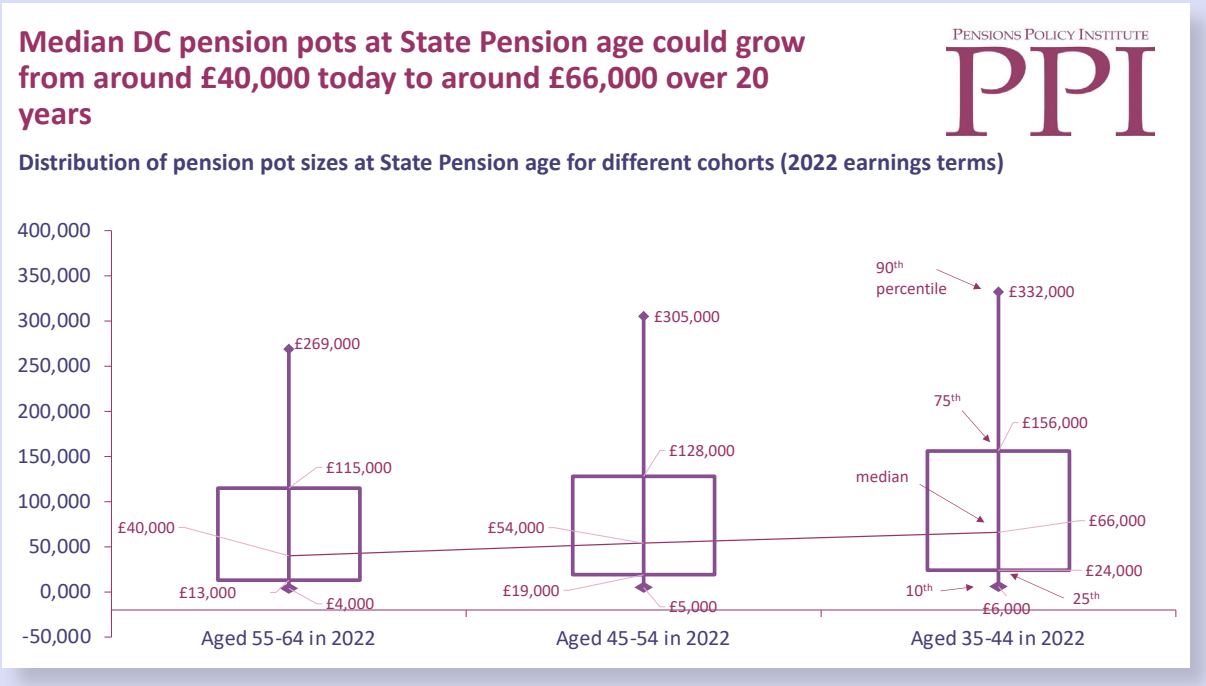
Box plots allow graphic representation of a distribution of outcomes. The rectangle represents the 25th to 75th percentiles of the distribution, while the ends of the vertical line represent the 10th and 90th percentiles. The horizontal line through the middle of the box represents the median.



Median DC pension pots at State Pension age (SPa) could grow from around £40,000 to around £66,000 over 20 years

Assuming that those currently contributing to a pension fund with their employer continue to do so, the median DC pension pot size at SPa could grow over the next 20 years from around £40,000 (for those aged 55 to 64 in 2022) to around £66,000 (for those aged 35 to 44 in 2022), all in 2022 earnings terms (Chart 3.2).

Chart 3.2[60]



The low average levels of DC pension savings that people will accrue over the next few decades means that many will be mainly dependent in retirement on income from the State Pension, State benefits and any DB pension or non-pension savings they have.

[60] PPI Aggregate Model

How might the aggregate value of private sector DC assets grow in the future?

The following section explores how the aggregate value of DC assets might grow based on certain assumptions about employee and employer behaviour, and under a range of potential future economic performance scenarios.

Box 3.5: Assumptions

The following analysis is based on the assumptions that:

- All eligible employees are automatically enrolled and existing savers remain saving.
- 15% of automatically enrolled savers opt out or cease contributing, before accruing any meaningful assets.
- Employee/employer contributions vary by scheme type:
  - Those in master trusts and other automatic enrolment DC schemes make contributions with their employers based on band earnings.
  - Existing savers continue contributing at the same rates, on total earnings (if applicable).
- Investment scenarios are a product of the PPI's Economic Scenario Generator (ESG), which uses data from Bloomberg. Long-term median rates are taken from the OBR's Fiscal Sustainability Report.
- Median nominal investment return is dependent on pension scheme and varies between 5.5% and 6%.[61]
- AMCs vary by scheme.

Economic assumptions are based on long-term OBR projections appropriate to the projection period.

By 2042, aggregate assets in DC schemes could grow to around £1 trillion

Assuming that current trends continue, the aggregate value of private sector workplace DC assets could grow from around £545 billion in 2022 to around £1.03 trillion in 2042. The aggregate value of assets is sensitive to economic performance. If the market performs very poorly, DC assets could stagnate, reaching around £814 billion by 2042. In a very positive market performance scenario, DC assets could grow to around £1.3 trillion by 2042 (Chart 3.3).

Box 3.6: Percentiles

The following charts illustrate how a range of economic scenarios could affect the value of DC assets. The values are shown in terms of the likelihood that they will occur:

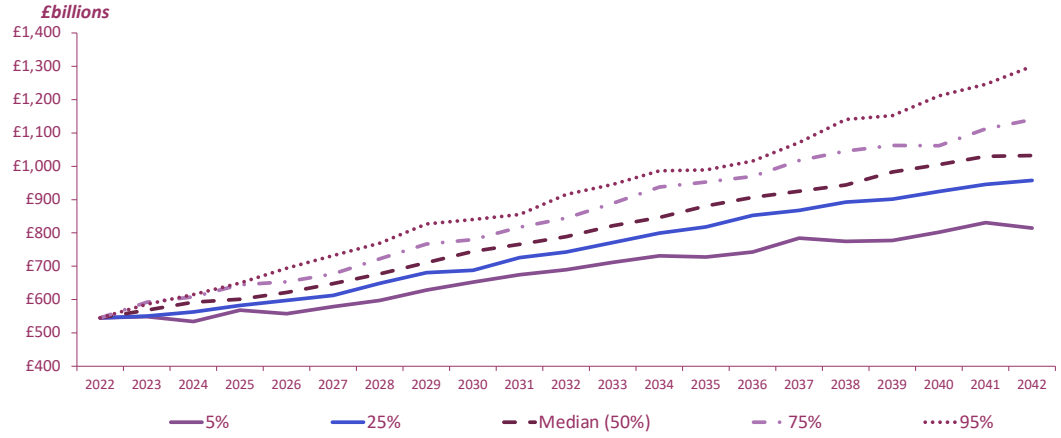
- The 5% line represents the very poor performance end; in the modelling only 5% of outcomes were worse than presented by this line.
- The 95% line represents the very good performance end; in the modelling only 5% of outcomes were better than presented by this line.
- The 25% and 75% points represent a 25% probability of relatively poor or relatively good performance respectively.
- 50% (median) is the central projected outcome, based on past performance.

[61] A blend of Office for Budget Responsibility (OBR) returns based on an asset mix to represent typical pension portfolios. The long-term economic assumptions are based on the OBR Fiscal Sustainability Report (July 2020).

Box 3.3[62]

By 2042, aggregate assets in DC schemes could grow to around £1.03 trillion (median outcome), compared to £545 billion in 2022

Aggregate value of private sector DC assets in the UK, by year, under 1,000 randomly generated economic scenarios (2022 earnings terms)



Employee and employer behaviour, and Government policy will all affect the aggregate value of DC pension schemes in the future

The aggregate value of private sector workplace DC schemes will vary, not just as a result of economic fluctuations, but also as a result of employee and employer behaviour, and Government policy. There are an unlimited variety of possible ways that these agents could behave in future, and each would have a different effect on the aggregate value of DC assets and the value of a member's pot at retirement.

Conclusions

In 20 years, there could be 10.6 million active members in master trust schemes, and 15 million active DC savers overall. The number of active members in private sector DB schemes could shrink from 981,000 in 2021 to 400,000 by 2041.

Median DC pension pots at SPa could grow from around £40,000 today to around £66,000 over the next 20 years.

By 2042, aggregate assets in DC schemes could grow to around £1.03 trillion, from the 2022 value of £545 billion. Investment performance, employee and employer behaviour, the economic and demographic backdrop, and Government policy will all affect the aggregate value of DC pension schemes in the future.

[62] PPI Aggregate Model: refer to the Technical Appendix for more details on the methodology

Chapter Four:

How will high inflation impact DC investment strategies?

Chapter Four: How will high inflation impact DC investment strategies?

This chapter explores the current environment of high inflation, the challenges it poses for Defined Contribution (DC) schemes and the options available to them for mitigating the risk to member outcomes. It is comprised of two sections:

- **The trajectory and impact of inflation increases:** This section sets out the background to issues caused by unexpected or significant increases in inflation.
- **The impact of high inflation on DC investment strategy:** This section investigates the impact of high inflation on different asset classes, and the lessons that may be learned for DC investment strategy.

Between the ongoing effects of the COVID-19 pandemic, the war in Ukraine and additional supply constraints, inflation has reached its highest level in 40 years. Unexpected and significant increases in inflation are likely to have far reaching effects for people during both their working-life/saving phase and during retirement. As DC forms an increasingly significant component of retirement savings for many, the current high inflation environment presents a considerable risk to DC pot values and, as a result, retirement outcomes, if those responsible for investment strategy do not consider and respond appropriately. When considering those who are responsible for making decisions about DC investment strategy, this covers a range of stakeholders, including: asset managers, investment consultants, Independent Governance Committees (IGCs), Trustee Boards, DC Committees, DC Governance Committees and DC Chief Investment Officers (CIOs) – as well as the members themselves. Individual DC savers should be aware of the threat of inflation when making decisions about investment, although most remain in the default fund and are likely to have the most appropriate protection against inflation by doing so, contributions and accessing their savings.[63]

While the long-term nature of DC investment means that decision makers need to be pragmatic when making changes to investment strategy, if high levels of inflation are sustained, they may need to consider steps that can be taken to introduce greater inflation protection into their portfolios. All those responsible for DC investment strategy should have a thorough understanding of the specific assets within which they are invested and the way in which they may be impacted by high inflation. However, while current levels of inflation are higher than have been seen in the UK for many years, a number of asset classes with either implicit or explicit inflation hedging have been developed and become more prevalent in the meantime. It is therefore worth exploring the factors between and within asset classes that could present the opportunity to deliver value in a high inflation environment today.

Box 4.1: Different measures of inflation

The trajectory and impact of inflation increases

This section describes the current inflation landscape, setting out the background to the challenges it poses to DC scheme investment.

[63] 96% of members of master trust and multi-employer schemes that responded to The PPI Asset Allocation Survey 2022 are invested in their scheme's default fund.

Box 4.1: Different measures of inflation

RPI: The Retail Prices Index (RPI) was established in 1956, replacing the Interim Index of Retail Prices, which in turn replaced the Cost-of-Living index (est. 1914) in 1947, and was the UK's lead measure of inflation from its inception. However, flaws in the formula, which resulted in RPI overstating inflation, led to the RPI losing its status as a National Statistic in 2013.[64] Consequently, the Government decided to bring the methods and data used in the calculation of CPIH (see below) into the RPI, while continuing to publish RPI separately. This change will take place from 2030.

CPI: The Consumer Prices Index (CPI) was originally developed in 1997 in order to comply with EU regulations that all member countries compile and publish a Harmonised Index of Consumer Prices (HICP) using the same methodology. The CPI measures the rise and fall in consumer prices including rental costs, but excludes owner-occupier housing (OOH) costs. CPI is still published to international standards in line with European regulations. The Government sets a 2% CPI target for the Bank of England to achieve in the medium term, while helping to sustain growth and employment.

CPIH: The Consumer Prices Index + Housing (CPIH), currently the lead measure of inflation, was introduced in order to provide a holistic measure of CPI with OOH costs included. OOH costs are those associated with owning, maintaining and living in one's own home, and include mortgage payments, insurance and maintenance costs.

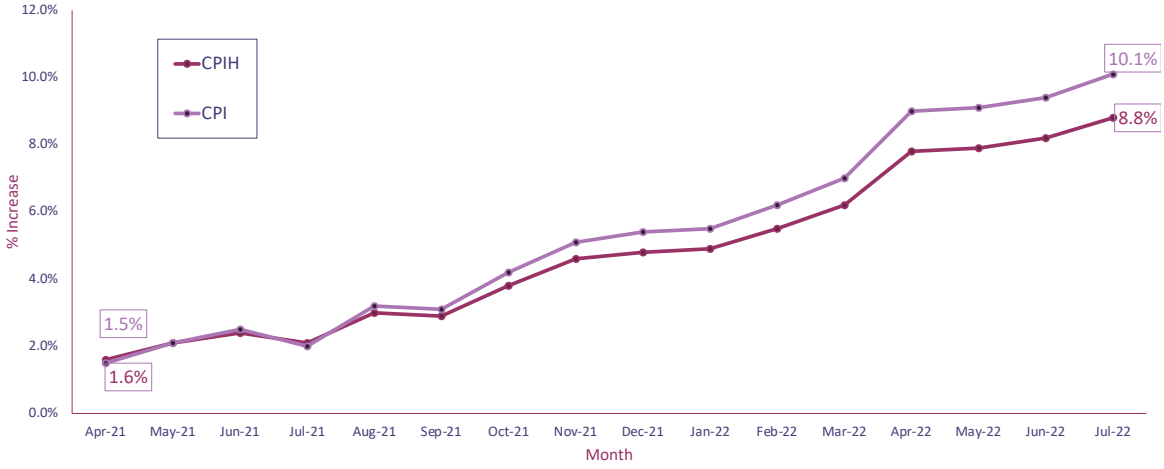
2022 has seen inflation reach its highest level in 40 years, with an extremely rapid increase in CPIH over the last year

The CPIH, which is currently the leading measure of inflation used to track the rate of household inflation in the UK, showed an annual increase of 8.8% as of July 2022, compared to just 1.6% in the year to April 2021, with inflation accelerating from mid-2021. At the same time, CPI (excluding OOH costs) has increased from 1.5% to 10.1% (Chart 4.1).

Chart 4.1[65]

CPI rose by 10.1% in the year to July 2022, compared to a 1.5% increase in the year to April 2021; CPIH increases have been lower but still substantial – from 1.6% to 8.8%

CPI and CPIH 12-month rate April 2021 – July 2022 (ONS)



[64] ONS (2018)
[65] ONS (2022c)

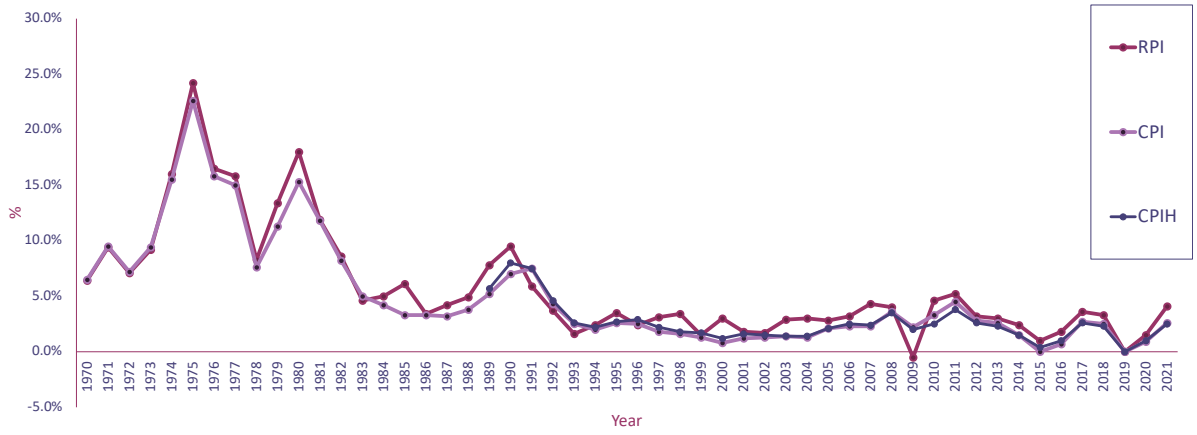
Increases in inflation have been rapid, leading to concerns that we could potentially soon see inflation increasing to levels not seen since the early 1980s. The 1970s and 1980s were a particularly challenging time economically, with a combination of high inflation and low economic growth, dubbed as 'stagflation' (Chart 4.2). From the mid-1990s to the onset of the global pandemic in 2020, inflation stabilised at a much lower rate. In the 15 years from 1993 to 2018, CPI averaged 2.1% annually. Economic growth also remained relatively stable over the course of the mid-late 1990s and into the 2000s, with the exception of 2008-09, resulting from the global economic crisis.[66] The period from 1997, when the Bank of England was granted operational independence to set interest rates, to 2007 became known as the NICE (non-inflationary constant expansion) decade, with the 'death' of inflation being widely predicted. However, with inflation now rising rapidly and the potential for a low-growth environment to develop, this is no longer the case. Despite a strong initial recovery in growth following pandemic-related lockdowns, there are concerns that it may have stagnated, with small declines in recent months, though it remains to be seen how this trend will develop.

Chart 4.2[67]

After high rates of inflation from the 1970s through to the early 1990s, inflation remained low from the mid-1990s and well into the new millennium, before increases began to materialise in mid-2021

PENSIONS POLICY INSTITUTE PPI

RPI, CPI and CPIH, UK, seasonally adjusted, 1970 to 2021 (ONS)



In contrast to most past episodes of inflation in the UK, which were principally demand-led, the current high inflation environment is principally attributable to global supply chain and other cost-push factors, such as rising input costs and labour shortages. While not completely comparable, the current economic situation has some parallels with the 1970s, when the quadrupling of oil prices resulted in persistent supply-side, or cost-push, inflation.

Although there are concerns about the combination of high inflation and low growth in the current environment, if stagflation does materialise, it is not expected to reach the same degree of severity as in the 1970s. As well as inflation not yet having reached historical highs of the 1970s, fiscal support is being offered to shield the most vulnerable to some degree.

[65] ONS (2022c)
[66] ONS (2019)
[67] ONS (2019)

Several factors, including the ongoing impact of the pandemic and the war in Ukraine, have combined to create the current environment of high inflation

During 2021 and the first half of 2022, many companies have been exposed to significant 'cost-push factors', including increasing costs of shipping and raw materials, export-related costs, rising wholesale energy prices and increasing wage pressures.[68]

A number of global and domestic factors have combined to create the current environment of high inflation

- Emergence from COVID-19 lockdowns impacting demand: As the UK economy opened back up following a series of consecutive lockdowns, pent-up demand from consumers helped restore economic growth, but also put a strain on supply chains which are struggling to return to pre-pandemic production levels.
- COVID-19 lockdowns, especially in China, impacting supply: As the world's largest manufacturer, recurring lockdowns in China, which have limited production, especially of key technology components, have had a significant impact on global supply chains.
- Reductions in the size of the labour force: In the UK, unemployment rates have reached a 50-year low, while the number of available job vacancies has surpassed the number of jobseekers for the first time on record. This may be attributed to lower incoming migration and a decline in labour market participation, particularly among older workers, as a result of the pandemic. Underlying factors such as minimum wage increases have also contributed to labour pressures, although widescale cost-of-living wage increases, which could prolong and exacerbate the current episode of high inflation, have yet to be seen.
- The war in Ukraine: The price of oil and gas supplies to Europe has risen, while global food supplies have also been impacted, as Ukraine is one of the largest global producers of sunflower oil, wheat, corn and other grains. The conflict in Ukraine, and the international response, pushed already elevated gas and oil prices to their highest levels in more than a decade. In 2021, the UK imported £200 million of food from the Ukraine, as well as £140 million of vegetable oils and fats, representing 0.5% and 11.3% of total imports respectively. With agricultural production in Ukraine severely impacted by the conflict, it is predicted there will be further pressure on supply and prices.[69]

High levels of inflation, especially over prolonged periods, have the potential to worsen retirement outcomes

Rapid increases in inflation, particularly if sustained over prolonged periods, can significantly impact DC outcomes. If returns achieved by the chosen investment strategy do not match inflation, DC pot values will be eroded in real terms, leading to poorer later life outcomes. While the primary focus of this chapter is the impact on investment strategy, high inflation is likely to have a broader range of effects across the DC landscape. Increases in price inflation are particularly significant for those on lower and fixed incomes, a group which includes many pensioners.

For those in the pension saving phase, high inflation may impact savers in two main ways:

- Increased pressure on their income from rising bills may reduce their ability to save, which could lead to increased opt-out rates and/or decreased contribution levels (for those saving above the minimum rate); and
- Pot values will be eroded if investment returns do not keep pace with inflation.

[68] Mann & Brandt (2022)
[69] Tetlow (2022); Mann & Brandt (2022); OBR (2022); ONS (2022d); Guenette et al. (2022)

The Office for Budget Responsibility (OBR) projects that real household disposable incomes per person will fall by 2.2% in 2022-23, the largest fall in a single financial year since the Office for National Statistics (ONS) records began in 1956-57.[70] The Government has already announced some measures aimed at mitigating the impact of the cost-of-living crisis, including a council tax rebate, reduction in energy bills and an increase in the National Insurance threshold.

For people in retirement, the effects of inflation on retirement outcomes will be more immediate. Pensioners are affected differently by cost-of-living increases because they spend on goods and services in different proportions to the rest of the UK population, and their income does not always increase at the same rate as the cost of living. The cost of living is increasing more quickly for pensioners than their income in 2022/23, particularly for costs associated with housing and energy, which will hit older and single pensioners hardest, as they spend more on these goods than younger and coupled pensioners.[71] However, as the State Pension triple lock will be reinstated for 2023/24, State Pension incomes will return to being increased by the higher of earnings, inflation or 2.5% after this year. This will provide some inflation protection for pensioners, but incomes drawn from DC savings will still be vulnerable to inflation risk.

Future levels of inflation are challenging to predict and standard economic policy levers may not be effective at managing the current situation

The Bank of England has increased interest rates to 1.75% as of August 2022, compared to 0.1% in November 2021. Because the current high levels of inflation have been largely driven by higher costs of production, energy and transport, increases to interest rates may not have the same effect as they would on demand-led inflation. Furthermore, with concerns about a possible return to 'stagflation', while increased interest rates may help to reduce inflation, the resulting increased borrowing costs might further depress growth.

It is hard to make predictions about the future trajectory of inflation, especially in the current economic landscape, and there are questions around whether current inflation increases are cyclical or structural – although most expect levels of high inflation to be transitory. Central banks have predicted that the recent rise in inflation will level out and inflation will gradually return to lower levels over time, although the absolute level of prices may remain elevated for some time. Supply shortages are expected to disperse as production returns to pre-pandemic levels, while continued global COVID-19 vaccination efforts are expected to reduce labour shortages currently present in the market.[72] In addition, it is expected that the countervailing forces of globalisation, demographics, de-unionisation and technology should regulate inflationary pressures over the long term.

The impact of high inflation on DC investment strategy

This section investigates the impact of high inflation on different asset classes and the lessons that may be learned for DC investment strategy.

[70] OBR (2022)
[71] Silcock [PPI] (2022)
[72] Mercer (2021a)

DC investment decision makers need to understand the way in which high inflation could impact their investment strategy

As the DC market has grown rapidly in recent years, DC investment strategies have generally been constructed during and for disinflation environments, which may mean they are no longer as effective in a high-inflation environment.[73] DC decision makers responsible for investment strategy (including the full range of stakeholders set out in the first paragraph of this chapter) could therefore benefit from developing a deeper understanding of the ways in which inflation may impact the risk and return profile of scheme assets. If high levels of inflation are sustained, DC schemes may need to consider how they can make changes to their investment strategy, including exploring alternative asset classes, in order to manage the threat posed by inflation being more persistent than anticipated.

Failure to account for inflation appropriately in DC investment strategies could cause pot values to be eroded and compromise the retirement outcomes of members. However, given the long investment horizons of pensions investment, decision makers must consider changes in investment strategy pragmatically. Considering the countervailing forces that regulate longer-term inflationary pressures, and the average DC saver's long investment time horizon, inflation should be viewed as an inherent risk over the course of DC investment, rather than an impetus for making wholesale changes to portfolio during times of high inflation. However, it is worth exploring whether there are practical ways of introducing greater or more effective inflation protection into investment strategy, as unlike during the period of stagflation in the 1970s and 1980s, there are now a range of accessible alternative asset classes that can potentially offer natural, implicit or explicit inflation protection.

The remainder of this chapter explores the impact of high inflation across a range of asset classes, including:

- Fixed-income assets
- Equities
- Private equity
- Infrastructure
- Commodities
- Real estate

For each asset class, the chapter discusses the ways in which it may be affected by high inflation and the potential responses or lessons to be learned within a high-inflation environment.

DC investment decision makers need to consider the long-term impact before making substantial changes to investment strategy

Before exploring the impact of high inflation on DC investment strategies across specific asset classes, it is worth reiterating the long-term nature of DC investment. DC schemes need to be pragmatic when making any changes to investment strategy, recognising that hasty changes made today in response to current high levels of inflation could put member outcomes at risk if they are not appropriately considered. High levels of inflation currently being experienced are expected to be transitory and are therefore unlikely to have a significant impact on outcomes over the long time horizons of most DC investors. DC decision makers need to be prepared to adapt to a range of inflation and growth scenarios, as well as a range of other risks that must be taken into account. However, this does not necessarily require them to make large scale

[73] Mercer (2021a)

shifts between asset classes within their strategy. Costs associated with changes to investment strategy must also be considered. The cost of changing portfolio holdings can be considerable, given the, sometimes significant, difference between buying and selling prices, broker's commission and stamp duty on purchases.

While fixed-income assets are considered less effective during periods of high inflation, investment decision makers need to view this through the lens of the long investment horizons of a DC scheme

In times of high inflation, fixed income assets, such as Government and corporate bonds, are likely to be considered less-effective components of investment strategy. High levels of inflation can impact bonds in two ways in particular:

- Eroded purchasing power: Bonds typically deliver fixed coupon and redemption payments, while the price of goods and services increases.
- Reduced bond value: If high inflation is accompanied by increased interest rates and, as a result, rising yields, bond values decline. Bond prices are inversely correlated with changes in yield, so that when yields rise, bond values fall, all else being equal.[74]

Government and some corporate bonds currently have low nominal and negative real yields, so a higher allocation to these within pension schemes' investment strategies could erode the value of DC pots, especially for those with long investment horizons before retirement. Holding bonds has a role to play in investment strategy in smoothing short-term volatility, but for longer-term investors this is likely to have a less substantial impact on eventual outcomes.

Bonds with shorter maturity are less heavily impacted by yield increases than bonds with longer maturity, and some have specific features that make them more attractive in high-inflation environments. While bonds that deliver a fixed income are less appealing during times of high inflation, the coupons and redemption payment from bonds with an explicit inflation link, such as UK index-linked gilts, are adjusted in line with RPI, and can, therefore, provide some protection against future higher-than-expected inflation (though changes to the way RPI is calculated from 2030 will erode the value of RPI-linked assets). UK Government bonds are also subject to the potential impact of the Bank of England's imminent unwinding of the quantitative easing undertaken during the pandemic.

Equities can provide growth within investment strategies during periods of high inflation, but performance is dependent on companies' ability to adapt to inflation pressures, which will require investors to fully understand this in order to identify value

Changes in inflation can also have an impact on equity holdings, so schemes may need to adjust their holdings in particular sectors or markets. In a high-inflation environment, equity performance can be impacted by sales declines, earnings declines and higher discount rates being applied to future earning streams, which may disproportionately affect certain sectors, such as technology, as well as those subject to increased raw material and labour costs. Schemes' decisions about allocation to equities is likely to become more complicated, as performance becomes more dependent on individual companies' ability to adapt to the rising cost of raw materials and labour.[75]

Certain specific sectors and types of company may be especially negatively affected by high inflation, even if they have previously performed well

During the peak of the pandemic, global equity market returns were mainly driven by a small number of US technology stocks as consumer behaviour shifted rapidly. This magnified the

[74] Greiner (2022)
[75] Morgan (2022)

variation between portfolio performance across different markets, investment managers and schemes, depending on whether they were over or underweight in their allocation to these investments relative to their peers. However, in the current high-inflation environment, the earning streams of technology companies have since become subject to considerable uncertainty and higher discount rates, resulting in significant underperformance.

Changes in economic factors across international markets can also make certain companies more vulnerable to the negative effects of high inflation. The prospects of companies heavily reliant on international trade can deteriorate if the terms of trade (the real, or inflation-adjusted, exchange rate) move against them. If the GBP exchange rate with international trading partners does not reflect the inflation differential between the two countries, for example, if CPI is higher in the UK than in the EU, UK exports will be more expensive and less competitive. In this case, GBP would have to weaken and the Euro strengthen in order for UK exports to remain competitive. Exchange rates will also affect the extent to which imported raw materials will increase the cost of manufacturing. Some companies are able to pass manufacturing cost increases onto the end consumer, but this is dependent on the pricing power of the company.

These additional considerations that arise from high levels of inflation can also mean that index-tracking investment strategies may be more vulnerable than an actively managed approach. All else being equal, an actively managed approach to equities, focused on carefully selected stocks in carefully selected sectors, is likely to deliver better returns, and provide a greater level of inflation protection, than a whole-of-market indexed approach. Although equities aren't necessarily a reliable short-term hedge against inflation, in the longer run they have consistently outperformed price and wage inflation, principally through strong dividend growth.

While high levels of inflation are clearly detrimental to the performance of fixed-income assets, for equities low levels of economic growth would be most detrimental, although inflation can also have an impact, as discussed above. If there is a return to a stagflation scenario like that of the 1970s, both bond and equity performance would suffer substantially. To ensure appropriate preparation for this possibility, those responsible for DC investment strategies may need to explore greater diversification and alternative asset classes in order to deliver positive real returns for members.

Private equity is vulnerable to many of the same pressures as publicly listed equities, but there is an evidence gap in terms of how it could be differentially impacted, especially if there is a return to stagflation

In a high inflation environment, private equity experiences many of the same challenges as public equity, facing the same supply chain constraints, input costs and labour shortages, with returns dependent on how well the investee companies can adapt to these pressures. However, there are some specific features of private equity arrangements that mean it may be impacted differently than publicly listed equities in some cases:

- Quantitative data on performance is often less readily available in the private market, making investors more reliant on having a good understanding of the qualitative pros and cons of a particular investment.
- Private equity returns can benefit from an illiquidity premium, as they are generally more challenging to trade than publicly listed investments. While this premium could help to boost returns, it is unlikely to be enough to fully protect against inflation when rates of inflation are currently so high.

- Some of the return delivered by private equity is reliant on the ability to finance the acquisition of companies with relatively inexpensive debt and to then reduce the company's operating costs in order to make it more effective. In the current environment of cost-push inflation, this approach is likely to become much more challenging.
- Any additional returns that can be delivered by private equity compared to public equity must be balanced against the increased cost associated with private investment, as well as the time taken for committed capital to be invested.

There is something of an evidence gap in terms of fully understanding how private equity investment might be impacted by different inflation scenarios that may develop in the near future, especially if there is a return to anything like stagflation. This is because the private equity market in its current form has yet to experience a period of stagflation, making it harder for investors to make predictions about the potentially negative impact that may be felt, and whether this will diverge from the experience of publicly listed equities. Taking into account that investors are likely to need a more developed understanding of how the companies they are invested in are able to adapt to inflation pressures in coming months, the issues related to data availability in the private equity market may make this more challenging.

While infrastructure can introduce additional inflation protection into portfolios, investors need to have a thorough understanding of the nature of the asset, its link to inflation and the contractual terms of their investment

Infrastructure is expected to outperform well in low-growth, high-inflation environments. However, as with many other asset classes, it is important that scheme decision makers understand the specific nature of the infrastructure within which they are invested and the contractual terms of their investment, most importantly, in this instance, whether inflation is explicitly covered in their contract. The inflation protection that can be provided through allocation to infrastructure takes many forms and varies across company and sector.[76] DC investment decision makers need to ensure that they understand the nature of inflation protection within the specific infrastructure in which they are invested.

Although infrastructure is often presented as an asset class that offers inflation hedging, this is only true of some sectors. Revenues of infrastructure companies are not necessarily indexed to inflation, although many infrastructure investments can provide at least a partial inflation hedge. Many infrastructure assets have an explicit regulatory or contractual link to inflation, while assets without an explicit link often have the flexibility of pricing power (i.e., passing increased costs onto consumers) to deliver similarly positive outcomes to investors during times of high inflation.

Regulated utilities generally provide a good level of protection against inflation as they usually have clear rules that are based either on an inflation index or on the evolution of prices and costs of goods and raw materials. Some suppliers also have State-defined tariff models that define a specific target profit, or allow full coverage of production costs through the levy of premium rates.[77] However, in instances where inflation protection is provided through price increases, investors need to consider the potential time lag between the onset of high inflation and a company's compensation through revenue.[78] In theory, this should not present a significant problem for long-term investors such as DC schemes, but investment decision makers should have a good understanding of the potential impact.

[76] Tsoneva et al. (2022)
[77] Swiss Life (2022)
[78] Tsoneva et al. (2022)

As a contributing factor to inflation increases, investment in commodities can provide protection, but must be balanced against Environmental, Social and Governance (ESG) considerations

Commodities have historically performed well during periods of high and rising inflation because they have a structural link to the inputs to inflation, which is to say that when commodity prices increase, so does inflation. There has been extreme pressure on commodity supply and prices in recent months, contributing significantly to the current levels of high inflation. However, as with other asset classes, the exact level of inflation protection offered by this type of investment will depend on the particular asset invested in and the way in which it is accessed. Gold is a partial outlier among other commodities. It is often viewed as a 'safe-haven' asset, which means that it tends to increase in value during times of economic uncertainty. This means that it performs especially well in periods when markets are either very weak or very nervous about high and rising inflation.[79]

As well as pressures from traditional inflation, DC schemes also need to consider concerns around 'greenflation' in relation to commodities. DC investors are increasingly focused on ESG considerations, driven by rapid regulatory change and a growing awareness of the financially material risks associated with ignoring these factors. Although recognition of the relevance of ESG factors has grown, developing knowledge and understanding of how to effectively integrate these factors into investment strategy is a more challenging undertaking. This is exacerbated by the complex relationship between the carbon footprint associated with producers of fossil fuels, metals and minerals, and the way in which many of these materials are required to support the development of renewable technologies, especially during the transition period. Some of the companies in sectors that are traditionally high carbon are also making substantial investment in working towards a low-carbon future, and in many cases produce the raw materials needed to support the transition to greener technologies. So, by divesting from these companies, investors may be withdrawing capital from companies who are leading low-carbon innovation.

Although negative screening or divestment continues to be a common approach to the incorporation of ESG factors into investment strategies, many investors are beginning to explore higher engagement strategies. However, with more investors looking to invest in ways that support the transition to a low-carbon economy, supply shortages of raw materials needed for the transition to greener technology are making it more expensive and harder to achieve. Prices of raw materials have already seen large increases as economies have reopened following pandemic-related lockdowns, and there are concerns around whether the current production levels and existing reserves of these materials will be sufficient to support the transition to greener technology. At the same time that demand for these materials is increasing, supply is stagnating, as investors focus on integrating ESG factors into their strategy. This has led to limited investment in fossil fuels and metals, further increasing the cost of these materials. While 'greenflation' is unlikely to cause DC investment strategies to backtrack on ESG progress, rising costs and limited supply of the raw materials needed for the creation of renewable technologies are likely to further complicate decisions about how best to allocate investment in order to meet targets and mitigate risks.

The transition to more sustainable energy sources is expected to drastically increase demand for: lithium, nickel, cobalt, manganese and graphite (for batteries); rarer earth elements (for wind turbines and electric motors); copper, silicon and silver (for solar panels); and copper and aluminium (for the underlying energy grid).[80]

[79] Mercer (2021b)
[80] Mercer (2021b)

Returns on real estate can be highly correlated with increases in inflation, but there is additional risk if growth stagnates

Real estate has often outperformed other asset classes during previous episodes of inflation, as leases and revenue streams are generally linked to inflation, whether directly or indirectly.[81] Depending on the type of real estate invested in, real estate can often pass inflation increases through into rental contracts and property prices, providing investors with returns that are correlated with inflation. There has been a strong correlation between inflation and rent increases over the last 50 years. During periods of high inflation between 1970 and 1990, the rent received by landlords grew by 10% per annum, while inflation averaged broadly the same. Rent increases then slowed to 3% per annum between 1990 and 2020 in line with lower levels of inflation.[82] In addition to rent cost increases, property values generally increase to reflect the increased price of commodities such as land, raw materials and labour costs. This can make real estate a good way to introduce some additional inflation protection into investment strategies.

However, increasing inflation is not the only uncertainty in the current economic landscape. With concerns about possible stagnation or declines in economic growth, the potential for recession would also have an impact on the returns real estate could deliver to investors. Property values are also sensitive to changes in interest rates, so investment returns could be impacted if the Bank of England further utilises this economic lever, whether conventionally or via the unwinding of quantitative easing.

Conclusions

With inflation reaching its highest level in 40 years and expected to rise further still, there are likely to be many impacts across the DC landscape. High levels of inflation, especially over prolonged periods, have the potential to worsen retirement outcomes. For people in the pension saving phase, high inflation may reduce their ability to contribute at an adequate rate, while pot values will be eroded if investment returns do not keep pace with inflation. For people in retirement, the effects of inflation on retirement outcomes will be more immediate, although the reinstatement of the State Pension triple lock for 2023/24 will help to protect them from the full effects of high inflation, but incomes drawn from DC savings will still be vulnerable to inflation risk.

In order to support positive retirement outcomes, DC investment decision makers may need to re-evaluate their investment strategy. However, it is important that they consider the long-term impact before making substantial changes to investment strategy. As in any economic climate, there are trade-offs associated with each asset class during times of high inflation, especially when coupled with uncertainty about future levels of growth (Table 4.1).

[81] BlackRock (2021)
[82] Schroders (2021)

Table 4.1: The impact of high inflation on investment strategy

Asset class	How/why it may be affected by high inflation.	Potential responses/lessons to be learned.
Fixed income assets	Eroded purchasing power/ reduced bond value through rising yields.	High levels of inflation expected to be transitory, so unlikely to have a significant impact on outcomes over the long time horizons of most DC investors.
Equities	Performance can be impacted by sales declines, earnings declines and higher discount rates applied to future earning streams, as well as increased raw material and labour costs.	Investors will need to develop a better understanding of their allocations in order to identify value and recognise companies' and sectors' ability to adapt to inflation pressures.
Private equity	Vulnerable to many of the same pressures as publicly traded equities, but could provide greater diversification and a boost to returns from illiquidity premium. In current cost-push inflation environment, private equity returns may be negatively impacted.	There is an evidence gap in terms of differential impact, compared to public equity, especially if low growth materialises alongside high levels of inflation.
Infrastructure	Can offer protection against inflation, but level of protection varies across company and sector.	DC investment decision makers need to understand the nature of the infrastructure within which they are invested, the contractual terms of their investment and the type of inflation protection this offers.
Commodities	Can provide protection against inflation, but dependent on nature of commodity and investment.	Levels of inflation protection will differ based on type of commodity and how it is accessed. DC decision makers also need to consider interactions with ESG factors.
Real estate	The correlation between rents/ property prices and inflation can introduce additional protection to portfolios.	Can introduce additional risk into the portfolio if growth stagnates or declines.

An overarching theme across the range of asset classes is that investment decision makers will need to be more educated about the finer details and characteristics of the specific assets in which they are invested. For long-term investors such as DC schemes, the appropriate response is unlikely to be one of large-scale divestment from any one asset class, but rather a more nuanced approach with a better understanding of the impact of inflation based on factors that can vary within an asset class.

Not all high-inflation environments are the same, and the impact on assets depends on how the situation develops over time, as well as other factors such as growth. Low growth coupled with sustained high inflation would be the worst-case scenario, with a return to stagflation not seen in decades. Under this scenario, most asset classes, with the exception of commodities, would likely suffer. However, it is generally not expected that we will return to the stagflation of the 1970s. There is an opportunity for those DC scheme investors that are open to exploring a more diversified approach, to get to know their investments in more detail, while balancing this with a pragmatic approach that recognises the long investment horizons and full range of risks faced by the scheme, in order to protect member outcomes.

Although it is difficult to make predictions about the future trajectory of inflation, failure to account for inflation appropriately in DC investment strategies could cause pot values to be eroded and compromise the retirement outcomes of members.

DC scheme decision makers need to be pragmatic when making any changes to investment strategy. Considering the countervailing forces that regulate longer-term inflation pressures and the average DC saver's long investment horizon, inflation should be viewed as an inherent risk over the course of DC investment, rather than an impetus for making substantial changes to a portfolio during times of high inflation, especially given the costs associated with making changes to investment strategy.

However, if high levels of inflation are sustained, there are practical ways of introducing more effective inflation protection into an investment strategy. This is because, unlike during the period of stagflation in the 1970s and 1980s, there are now a range of accessible alternative asset classes that can potentially offer natural, implicit or explicit inflation protection.

Chapter Five:

Reflections on policy

Chapter Five: Reflections on policy

DC pensions and high inflation

Paul Johnson, Director, IFS

For 40 years we have barely had to worry about high inflation. For more than 20 years it has averaged around 2%. We have built our lives and our public policies around the assumption that this state of affairs would continue. That assumption has, as was always eventually going to be the case, now been proved false.

Our pension policy, meanwhile, has become increasingly reliant on individual savings pots to top up the state pension. That has meant transferring all risk to individuals. They now face the consequences of high inflation.

For those in the accumulation phase the question is whether the returns they can earn will match or exceed inflation. I don't know the answer to that, but the poor real economic performance we can expect across the developed world in the face of the current energy price shock is likely to depress returns.

A second consequence, entirely amenable to government action, will be the swift diminution in the real value of the annual and lifetime allowances. The annual allowance has already been frozen at £40,000 since 2014. It will lose more than 20% of its real value over the next couple of years if it remains frozen, dramatically increasing the numbers affected. Government needs to act on this or it will start to bring the era of Defined Contribution (DC) pensions to an end just as surely as the Defined Benefit (DB) era has closed.

Of more immediate concern is the impact on current and near future retirees. Few who have retired with a DC pot have taken out inflation protected annuities. With index linked rates of less than 3.5% at age 65 that is perhaps unsurprising. The consequences for the several hundred thousand who appear to have chosen early retirement in the wake of the pandemic remain uncertain. Their real resources are likely to be substantially less than expected.

This has crystallised the risks created by our "pension" policy. The move from DB to DC, and away from compulsory annuitisation, has turned what were pensions, with risk sharing between employee and employer, between long and short lived, into little more than tax advantaged savings pots. Those are difficult enough to manage, especially in the drawdown phase, in normal, stable times. How one is supposed to manage in the face of high and volatile inflation I really don't know.

The current economic volatility has revealed the emperor's new clothes for what they really are. We have no policy for private pensions as usually conceived. We have auto-enrolled millions into individual savings pots, left them to bear all the risk, ended risk sharing, taken away the duty to buy a pension, and provided no protection against the sort of problems we now face. We have moved from the absurdity of providing guaranteed, defined incomes for life from a fixed age paid for by companies and current workers, to the absurdity of leaving people entirely unprotected against all and any risk.

We have been complacent about our pension policy for far too long. If there is to be one good thing coming from our current travails, it is to be hoped that it will be a shaking off of that complacency.

Considerations for DC scheme members and scheme managers in the face of rising inflation

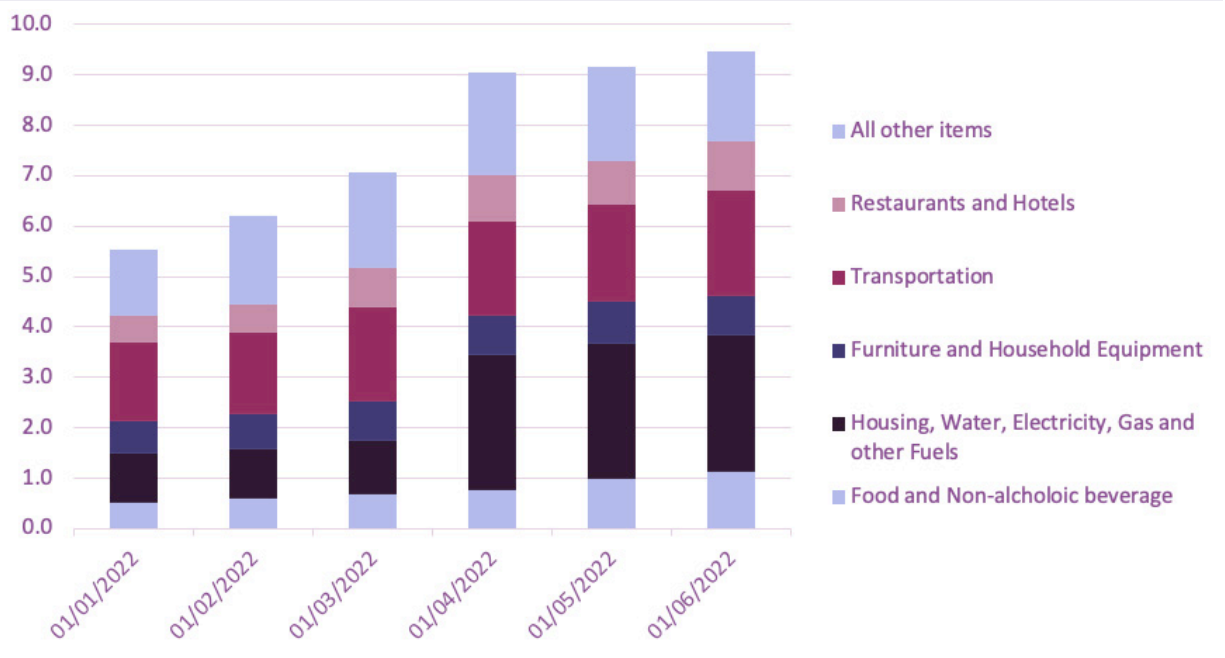
Madeline Forrester, Managing Director – Head of Global Consultant Relations, MFS, and PPI Chair of Council

Rising inflation has emerged as a major macroeconomic risk in the UK and globally, and presents challenges for both DC scheme members and scheme managers. For members, risks are the greatest in the decumulation phase of the retirement savings journey, while DC scheme managers should consider whether options available to members include sufficient inflation-protection components within the overall asset allocation.

For decades, inflation has been largely an afterthought for retirement scheme members and DC scheme managers. In the 80s and 90s, most members were covered by DB schemes, which generally provided annual cost of living adjustments. And, while the past two decades have seen a seismic shift from a predominantly DB-based to a DC-based system, inflation for the most part has been low, averaging roughly 2% between 2000 and 2021. However, inflation, which today is elevated by historical standards, is likely to continue to rise in the months ahead.

The key contributors of UK inflation in recent months have been housing, energy, transportation, and food (Chart 5.1). Looking ahead, a combination of persisting supply-side disruptions and elevated wage pressures could push inflation into double-digit territory by the end of the year. Another source of inflation risk includes the looming energy price cap increase that is scheduled for October.

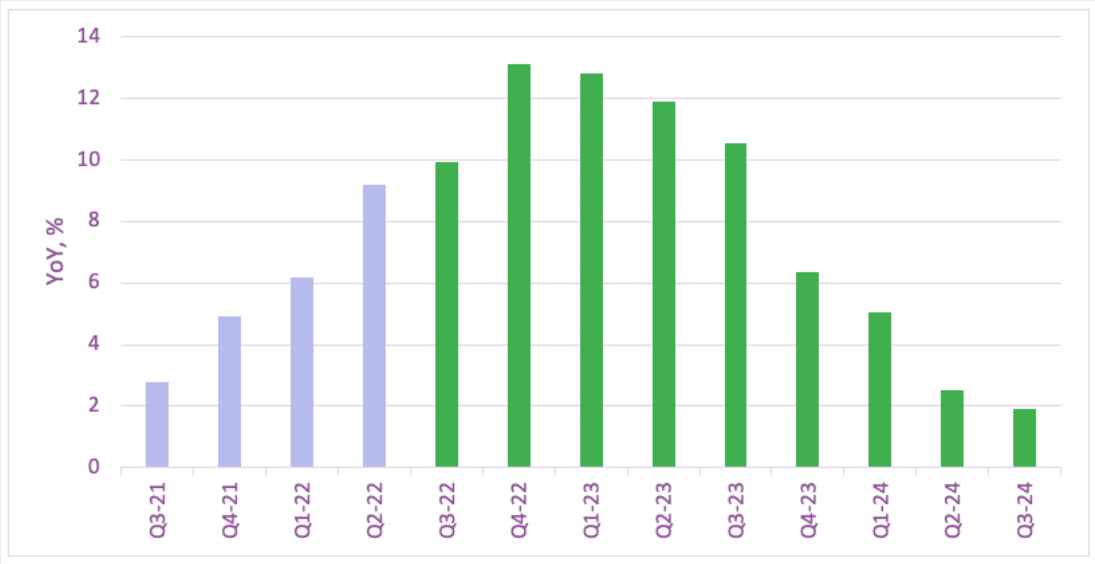
Chart 5.1: Looking into the Components of UK Inflation[83]



Inflation is likely to remain a serious risk over the medium term. Long-term inflation estimates from the Bank of England (BoE) project inflation to stay elevated through 2023 at least (Chart 5.2). While inflation is projected to stabilise at more normal levels beyond 2023, risks remain skewed to the upside.

[83] Bloomberg, UK Office For National Statistics. Monthly data starting in January 2022 up to June 2022. UK CPI EU Harmonized YoY NSA

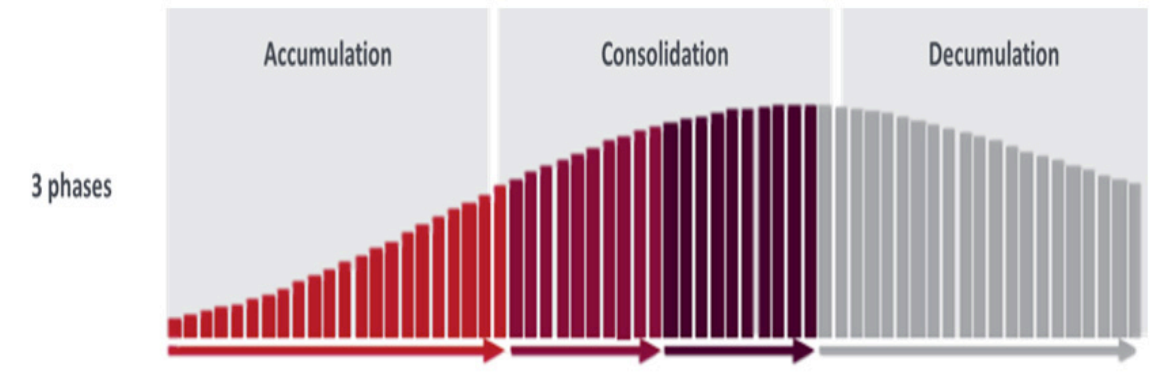
Chart 5.2: UK Inflation: Actual and BoE Projections[84]



Inflation and the Retirement Savings Journey

Inflation impacts members differently depending upon where they are in the retirement savings journey, as depicted in Chart 5.3.

Chart 5.3: The Retirement Savings Journey



Key member goals	Save and Grow	Grow with Risk Awareness	Protect and Generate Income

For illustrative purposes only.

The primary goals in the accumulation phase are to encourage members to save as much as they can afford and grow savings pots through compounding investment returns over a long time horizon. This long horizon generally allows members to assume a higher level of investment risk, typically through allocation to higher-growth assets, such as equities. These have historically outpaced inflation over the long term, and a short-term spike in inflation is unlikely to have a meaningful impact on long-term retirement objectives.

[84] Bloomberg. Quarterly data for CPI. UK Office for National Statistics. Bank of England for projections starting in Q3-2022 (green). August 2022 Monetary Policy Report, Projections based on market interest rate expectations. Mean CPI projections.

However, the impact of rising inflation is more pronounced in the consolidation and decumulation phases, where goals are often more complex and the allocation to fixed income, which tends to be more vulnerable to inflation risk, is likely to be higher.
Regardless of the inflationary environment, we believe that broad portfolio diversification is critical throughout the retirement saving journey. This is particularly true for fixed-income allocations in the later stages of the journey, where exposure to a variety of fixed-income sectors, such as Gilts, credit, global and high yield, can help protect portfolios against a wide array of risks.

In the current inflationary environment, there are a variety of asset allocation adjustments that DC scheme managers and members might consider. Increasing the allocation to short-term bonds, which have less interest-rate sensitivity (i.e., duration) than other fixed-income strategies that hold debt with longer maturities, can help protect against potential further rises in rates. Likewise, inflation-linked bonds, which seek to help investors preserve and protect their purchasing power, can play an increasing role in retirement-oriented portfolios. Conversely, high-yield bonds could struggle in a higher inflation environment, as could emerging market debt (EMD), although given the wide array of issuers in the EMD space, there could be opportunities with issuers that could benefit from higher inflation (e.g., commodity exporting countries).

Increased rates and yields could however offer a silver lining for investors. Our research has shown that starting yields are often a good predictor of subsequent long-term returns, regardless of the interest rate or inflationary environment that follows. Current Gilt and global bond yields near 2% and 3% respectively, suggest potentially more attractive future returns than those asset classes have offered in recent years, and investors who have eschewed low-yielding fixed income over the past few years may want to give the asset class another look.

Over the long term, equities by their nature have been good hedges against inflation, however in the current environment, we believe there could be a wide range of outcomes in how companies manage through higher inflation. Companies with greater pricing power should be able to better maintain margins and profitability, while others may struggle, particularly companies that sell products that can easily be substituted for lower-cost alternatives. Accordingly, we believe an active approach to security selection could help investors better weather the storm. Allocations to real assets, such as real estate, infrastructure and commodities, may also help improve the inflation-protection characteristics of the portfolio.

While further diversification and tactical adjustments can help protect portfolios in the current environment, we caution DC scheme managers and members from making significant changes to their strategic asset allocation, keeping in mind the long-term time horizon for most members. DC scheme managers should also keep an eye on potential secondary effects of inflation on members. With automatic enrolment now firmly entrenched within UK DC schemes, it is unlikely that inflation will undermine participation levels in a major way. However, there is a risk that members allocate more resources to cover their rising living expenses, and correspondingly less to their pots, to the detriment of their long-term objectives.

Overall, elevated inflation risks constitute major challenges for DC schemes, and DC scheme managers should review their portfolios, particularly those geared towards members closer to retirement, to ensure they have proper diversification to help manage the current inflationary environment, while still managing towards meeting long-term member goals.

High inflation, saver choices and system design

Stephen Mcdonald, Head of Economics, Which?

The UK is experiencing high levels of inflation for the first time since automatic enrolment and the pensions freedoms were introduced. We should expect it to affect savers' choices. It will be some time before the data is available to tell us exactly how, but we can set out likely outcomes and reflect on how well parts of the DC landscape are working for members.

On the accumulation side, increased financial pressure on households will probably lead to lower pension savings as more people opt out from automatic enrolment, or make an active choice to stop saving despite being already enrolled. This could lead to long-term harm if those who stop saving do not restart when their finances improve, but this doesn't feel like a major concern.

Even though the squeeze on household finances is expected to worsen sharply over the coming months, and continue throughout 2023, it would be a surprise if opt-out and active cessation rates increased sharply because the inertia underpinning automatic enrolment is incredibly strong.

Further, the risk of long-term harm is mitigated by the requirement on employers to automatically re-enrol eligible workers every three years. It looks like the total number of employees who have been automatically re-enrolled will pass one million in the coming year, underlining the importance of this requirement.

The more telling impact of inflation on savers' decisions is likely to be in how and when they access their DC savings, and I can see two undesirable features of the current landscape that could be exacerbated by the current cost-of-living crisis.

First, it might lead to more people cashing out pension pots early and not keeping them for retirement. Savers are increasingly holding multiple pension pots and the proliferation of small, often very small, pots is well documented. However, people's decumulation decisions are not independent of how their pension wealth is spread across pots and full withdrawals are more common for smaller pots.

Which? has explored this using experimental research. We gave participants a fictional allocation of pension wealth and asked them to make decumulation decisions. We found that people with multiple, smaller pots were more likely to cash them out early to pay for unexpected expenses. The large decline in the number of full withdrawals between April 2020 and March 2021 was unsurprising, as the pandemic reduced opportunities for consumer spending. It would be equally unsurprising if the number of full withdrawals increases substantially in the coming year as households are placed under financial pressure from high inflation.

We can't judge whether a saver is making a good decision if they cash out a pot, as they are best placed to know their own needs. However, people using small pots of pension savings to cover living costs while still in employment was clearly not the policy intention. The implication is that the (safe) consolidation of pots needs to be made easier, with auto-consolidation for small pots, so that people's decumulation choices are not unduly shaped by how their savings are distributed across pots.

Second, although the current economic situation shouldn't in principle make drawdown decisions more difficult, as the inflation risk was always present, it clearly makes the risk more salient. This should lead us to reflect again on how well individual savers are able to manage this. With so many savers purchasing income drawdown products without advice, then it is essential that an appropriate, institutionally-managed drawdown product is available as a default option.

The FCA should be praised for the introduction of investment pathways, with the duty for Independent Governance Committees (IGCs) to oversee their value for money, and rules to deter consumers investing mainly in cash. We now need to see similar changes to the trust-based side of the market and it is welcome that the Department for Work and Pensions (DWP) is working on this. However, it is also important that the Financial Conduct Authority (FCA) evaluates whether investment pathways are making enough of a difference to retirement outcomes.

We all recognise that DC pensions place the burden of risk, including inflation risk, on members. If they can't be adequately supported to manage this, then we need to think more radically about encouraging hybrid schemes that pool this risk.

Investing in real estate: an untapped, responsible investment opportunity for DC schemes

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Almost all UK DC schemes still predominantly invest in highly liquid asset classes, despite most being characterised by positive cash flow and a long-term investment horizon. As a result, they are missing out on the many longer-term, less liquid asset opportunities, diverse risk premia and return drivers that populate the portfolios of most DB schemes. Of these asset classes, real estate stands tall.

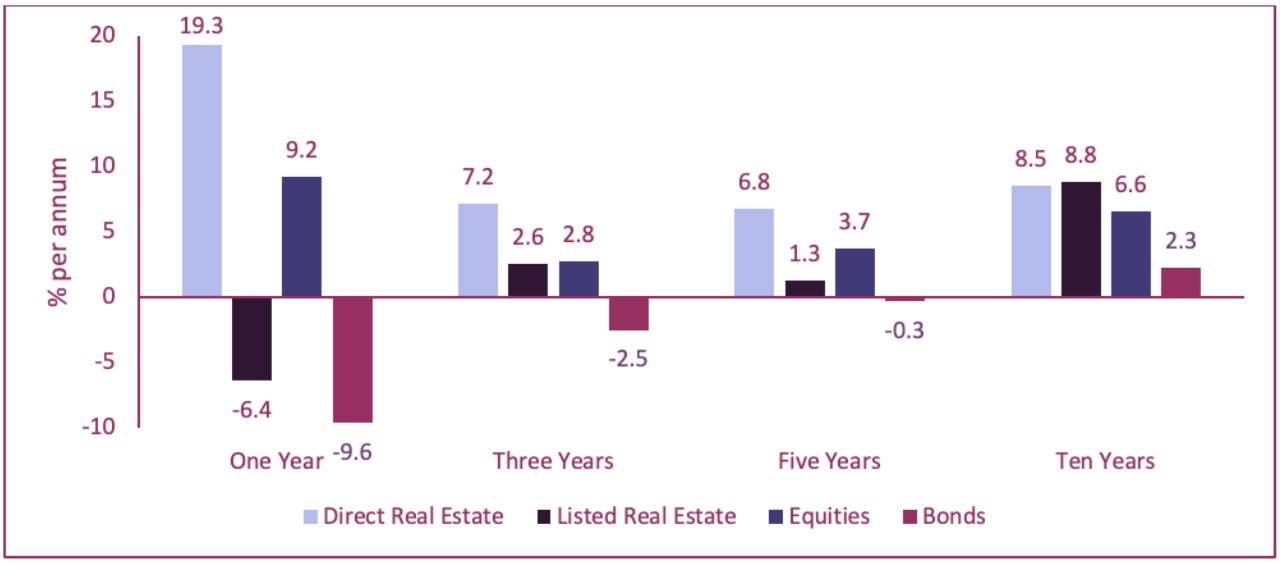
The investment opportunity

Real estate offers contractually secure income, capital preservation underpinned by a real tangible asset, and the opportunity to create long-term additional returns through active asset management. This includes future-proofing returns by refurbishment incorporating Environmental, Social and Governance (ESG) improvements.

The asset class also enables investors to align their portfolios in accordance with their beliefs, as it offers scope for positive impact investing around regeneration, placemaking and the ability to tackle wider social issues, for instance through the provision of quality, professionally managed affordable housing. Many of these themes align with wider government initiatives such as the "levelling up" agenda.

When looking at the performance of difference asset classes over one, three, five and 10 years, direct real estate outperforms over most time periods (Chart 5.4). Direct real estate investment is the full or partial acquisition of a physical building, while listed real estate means investing in companies or vehicles quoted on an official stock exchange.

Chart 5.4: Performance across asset classes[85]



Note: Results shown here for direct real estate and fund-level real estate are based on separate quarterly specific sources indicated below:

As at date end June 2022

A hedge against inflation

Real estate, it is often argued, is also a good hedge against inflation, which continues to rise and is likely to be persistently higher – and more enduring – than expected.

Different sectors within real estate offer varying degrees of inflation alignment. In the commercial space, rents can often be linked to inflation, albeit typically with caps and collars in place. Lease structures with lease renewal provisions and/or rent reviews also provide the opportunity for rents to be adjusted to market at specified times, potentially capturing any inflation gains.

In the residential sector, income growth and capital values also have a very strong positive correlation to long-term inflation. Additionally, a higher inflationary environment and uncertainty over mortgage rates can increase demand within the rental market as home ownership becomes increasingly unaffordable. With a continued lack of supply, investing in residential real estate can deliver enhanced income growth for investors.

That's why this sector is considered to be a defensive investment when inflation is elevated. Because of these diversification benefits, and the strong structural demand drivers, granular income and the potential to deliver on their social agenda, many investors now view it as the alternative sector of choice.

[85] Sources: EQUITIES, MSCI, MID & Large Cap, Index, Total Return, GBP BONDS/FIXED INCOME: JP Morgan. GBI Broad, Traded, Index, 7-10 Year, Total Return, GBP, PROPERTY EQUITIES: MSCI, GB/Real Estate, Gross Total Return, GBP, series#115565; DIRECT REAL ESTATE (ASSET LEVEL); MSCI, MSCI UK Quarterly Property Index (and monthly index); NET FUND LEVEL REAL ESTATE; MSCI, MSCI UK Quarterly Property Fund Index

The social investment opportunity: an example

The UK government is increasingly seeking private finance to deliver regeneration, renewal and enhanced provision of affordable housing accommodation. The emerging consensus that capitalism should be more inclusive to wider society is quickly establishing itself in mainstream investment thinking. After years of being considered niche, the growth of sustainable and impact strategies being incorporated into real estate managers' investment policies is facilitating genuine change in many areas of society and the environment.
Housing represents a key tool for developing cities looking to cope with growing, transient and ageing populations that require employment and social infrastructure such as somewhere to live and access to healthcare and education. For investors, this can mean diversification between the private rented sector, affordable housing, hotel-apartments and senior living – it is diversification within diversification. Long-term rental housing in particular is lowly correlated to other more cyclical property asset classes. The various leasing models associated with affordable housing also offer scope for inflation-linking, but with an ongoing view to the holistic affordability of schemes. The consistent income of the sector and inelastic demand has helped reinforce it as a credible source of diversification and sustainable income.

Additionally, the development and operation of housing presents the opportunity to drive long-term environmental change through forward-looking designs that create operationally efficient homes, reducing carbon footprints and enabling social benefits such as less energy poverty. Credible impact investment in real estate demands that investors consider all these aspects.

Structural change influencing diversification

As always, asset selection remains crucial. When investing in real estate, it needs to be the right asset in the right location, able to fulfil the demand for ESG criteria, and underpinned by the right fundamentals that can offer long-term positive rental value growth.

In this context, the wider real estate sector continues to reinvent itself, offering increasing variety to investors up and down the risk curve. It provides solutions to structural changes that are happening in the world today, as well as those that will be encountered tomorrow: technological advances; demographic changes and ageing populations; changing consumer demands; and climate change and sustainability, among others.

Different sectors are moving through the cycle at different speeds and/or in different directions, offering investors counter-cyclical plays. No sector is immune to change from these structural forces, but there are areas of the market that will offer better opportunities to generate positive real returns. Urban logistics, for example, is driven by and responding to the structural changes in online consumption and consumer demand for ever-shorter delivery timeframes.

All that said, there are both real and imagined impediments to DC schemes investing in illiquid assets. However, they are not insurmountable.[86] A report in 2021 by the Productive Finance Working Group (PFWG)[87] encourages DC scheme trustees, trade bodies and consultants to consider how increasing investment in less liquid assets could generate greater long-term value for their members and diversify portfolios. The PFWG also recognises the risk to schemes of focusing on the cost, rather than the potential value-add, of illiquid assets and, unsurprisingly, adds to calls for consolidation in the DC market so that schemes have the necessary scale and investment governance to make a meaningful allocation to these heterogeneous assets.

[86] These impediments principally comprise increased due diligence, accommodating higher management and sometimes performance fees within the 0.75% charge cap, high minimum investment sizes and the inability of most insurance platforms to offer and administer illiquid assets. 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.

[87] A roadmap for increasing productive finance investment. The Productive Finance Working Group. September 2021. The TPFWG is co-chaired by the Governor of the Bank of England, the Chief Executive of the FCA, and the Economic Secretary to Treasury. See: https://www.bankofengland.co.uk/report/2021/a-roadmap-for-increasing-productive-finance-investment

As an industry we need to continue to work together to remove the real and perceived barriers that currently prevent DC schemes investing in illiquid assets. If we manage to do so, the opportunities are plentiful, particularly for those wishing to link their investments to social or environmental outcomes. The myth that for high-quality impact to be achieved, the appropriate financial returns must either be a secondary factor or an additional consideration, has been proven false. Certainly, the provision of well-governed, affordable housing solutions offers clear social and environmental benefits, as well as opportunity for returns for investors.

Appendix

Modelling Assumptions

Appendix

The modelling for this report considers the projection of an individual using the PPI's Suite of Pension Models, and a stochastic approach of economic assumptions. The economic scenarios are generated using the PPI's Economic Scenario Generator (ESG). The Models used are detailed below. Results are presented in 2022 earnings terms.

The pensions system

The pension system modelled is as currently legislated. The triple lock is assumed to be maintained. Individuals are assumed to be members of a Defined Contribution (DC) occupational pension scheme.

General assumptions

Investment returns are modelled stochastically with curves generated by the PPI's ESG. 1,000 scenarios were produced providing values for equity returns, bond returns, cash returns, Consumer Prices Index (CPI) and earnings increases each year for each scenario. The assumed median values for each of these values are listed below, these are based on Office for Budget Responsibility (OBR) long-term assumptions:

CPI: 2.0%
Earnings: 3.8%
Equity return: 7.0%
Bond Return: 4.0%
Risk-free Return: 2.0%

Other economic assumptions

Other economic assumptions are taken from the OBR's Economic and Fiscal Outlook (EFO) for short-term assumptions, and Fiscal Sustainability Report (FSR) for long-term assumptions.

Asset allocation

Unless otherwise specified, asset distributions are assumed to be 56.7% invested in equities, 33.3% invested in bonds and 10% in cash, such that the median return is 5.8%. These assumptions are consistent with those used across the PPI Modelling Suite and are the result of consultation with the PPI's Modelling Review Board, which consists of a number of experts in the field of financial modelling.

Fund charges are assumed to be 0.75% for existing workplace DC schemes,[88] and 0.5% for other DC/master trust schemes set up for automatic enrolment.[89]

Earnings growth and other economic assumptions are taken in line with OBR assumptions,[90] derived from their 2019 long-term economic determinants.
The earnings band for automatic enrolment contributions and minimum salary assumptions are assumed to grow with average earnings.

[88] Average charges for trust-based schemes are 0.71% and for contract-based schemes 0.95%, DWP (2012), and a 0.75% charge cap will be introduced for any DC default funds being used for automatic enrolment from April 2015 onwards.
[89] Equivalent Annual Management Charge for multi-employer/Master trust schemes such as Legal and General's Worksave, NEST and The People's Pension.
[90] OBR (2019)

The Economic Scenario Generator (ESG)

The PPI's ESG is used to produce randomly generated future economic scenarios based upon historical returns, and an assumption of the median/long-term rates of return. It was developed by the financial mathematics department at King's College London. It is used to test how the distribution of outcomes is influenced by the uncertainty of future economic assumptions.

Key results

The Model generates projected future inflation rates, and earnings growth

- Inflation rates
  - Future CPI increases and earnings inflation rates
- Investment returns
  - Returns are produced for the major asset classes of equity, cash and gilts

This produces nominal returns which can be combined to produce investment returns for a more complex portfolio.

Application of output

The output of the ESG is a number of economic scenarios which are employed by the PPI's other models to analyse the distribution of impacts on a stochastic economic basis.

Key data sources

The specification of the model s based upon historical information to determine a base volatility and future assumptions to determine a median future return:

- Historical returns: Historical yields and returns, as well as inflation measures, are used to determine the key attributes for the projected rates.
- Future returns: Future returns are generally taken from the OBR's EFO to ensure consistency with other assumptions used in the Model for which the economic scenarios are being generated. Volatility can also be scaled against historical levels.

Summary of modelling approach

The six identified risk factors modelled are:

G	Nominal GDP
P	CPI
W	Average weekly earnings
Y1	Long-term yields
Ys	Money market yields
S	Stock returns

Using these variables, a six-dimensional process, x_t is defined.

$$x_t = \begin{bmatrix} \ln G_t - \ln G_{t-12} \\ \ln(P_t - \ln P_{t-12} + 0.02) \\ \ln W_t - \ln W_{t-12} \\ \ln\left(e^{Y_t^l} - 1\right) \\ \ln(e^{Y_t^s} - 1) \\ \ln S_t \end{bmatrix}$$

Where t denotes time in months.

The development of the vector x_t is modelled by the first order stochastic difference equation:

$$\Delta x_t = A x_{t-1} + a + \varepsilon_t$$

Where A is a 6 by 6 matrix, a is a six-dimensional vector and ε_t are independent multivariate Gaussian random variables with zero mean. The matrix A and the covariance matrix of the ε_t were determined by calibrating against the historical data. The coefficients of a were then selected to match the long-term economic assumptions.

It follows that the values of x_t will have a multivariate normal distribution. Simulated investment returns will, however, be non-Gaussian partly because of the nonlinear transformations above. Moreover, the yields are nonlinearly related to bond investments.

The first and third components of x_t give the annual growth rates of Gross Domestic Product GDP and wages, respectively. The fourth and fifth components are transformed yields. The transformation applied ensures that the yields are always positive in simulations. Similarly, the second component gives a transformed growth rate of CPI. In this case, the transformation applied ensures that inflation never drops below -2% in the simulations. This figure was selected to be twice the maximum rate of deflation ever found in the historical data.

PPI Aggregate Model

Overview of Aggregate Modelling of Private Pensions

The PPI Aggregate Model links changes in the UK population, the labour market and economic assumptions to project forward private and State pension savings. Population projections are taken from 2016-based figures published by the Office for National Statistics (ONS).

Current distributions of individuals across pension scheme types are taken from the Lifetime Labour Market Database (LLMDB),[91] a panel dataset of 1% of UK National Insurance records. The workforce data includes numbers of individuals and average earnings split by age, gender and earnings band. The data are further split between public and private sector contracted-out schemes, and those who are contracted-in to the State Second Pension (S2P).

Initial Conditions

In the base year of projection (2010), individuals with private sector pension arrangements are split between public and private Defined Benefit (DB) schemes and workplace DC schemes. 17.5% of working individuals are assumed to be members of DC workplace pensions and 32.1% of individuals are assumed to be members of DB workplace schemes.[92] 73.2% of those in DB schemes are assumed to work within the public sector,[93] leaving 8.6% of the workforce in private sector workplace DB schemes.

The workforce not initially enrolled in public sector DB, private sector DB or private sector workplace DC, are considered as the eligible population for automatic enrolment. This includes individuals not in workplace pension schemes who contribute to personal pensions.

Stocks of existing assets for DB schemes and workplace DC schemes are split across cohorts by contribution levels. Initial stocks of workplace DB assets were assumed to be £890 billion in the base year.[94] It was assumed that the stocks of DC assets in 2010 were £275 billion.[95]

[91] Data from LLMDB 2010-11
[92] ONS (2013)
[93] Average proportion of males and females employed in public sector COSR schemes according to LLMDB 2010-11
[94] TPR (2012) The Purple Book Chapter 4 Table 4.1 Assets discounted to the base year.
[95] Workplace DC assets taken from ONS (2012) Table 3, adjusted for decumulated assets.

Movement of individuals between schemes due to decline in DB schemes

The proportion of individuals in each scheme is not stable over time: the proportion of the total workforce who are enrolled in a private sector DB scheme is assumed to decline by 80% between 2010 and 2030, and these individuals are moved into the existing DC workplace schemes.

Movement of individuals between schemes post automatic enrolment

From 2012, employees in the private sector without workplace DC provision are placed in a scheme to represent automatic enrolment, which is split further into master trust schemes and other DC schemes, assuming 80% are automatically enrolled into master trusts and the remaining into other DC schemes. Individuals are enrolled in proportion to the likely number of employees becoming eligible each year, due to staging of their employers. Similarly, during the staging period, employees in existing DC schemes who become eligible for automatic enrolment either remain in the existing scheme or are moved to a new automatic enrolment workplace DC scheme (again split into master trusts and other DC schemes in the same proportions as mentioned above). It is assumed that 80% of existing members remain in their current scheme, and 20% are expected to move to the new automatic enrolment scheme. New members to DC schemes who have an employer with an existing scheme either join the new automatic enrolment scheme (80%) or join an existing DC scheme (20%).

Overall, after 2012 the private sector workforce is assumed to contribute to either private sector DB pension schemes, DC schemes which were existing prior to automatic enrolment, DC schemes which were set up for automatic enrolment, or DC schemes set up for those that are eligible for automatic enrolment that did not contribute before its implementation. It is assumed that 14%[96] of the workforce change jobs from year to year, which causes individuals to shift from existing DC schemes into new DC automatic enrolment schemes over time.

Contributions

Contributions are taken as a percentage of total earnings for employer-provided schemes (both existing schemes and those set up after automatic enrolment) and are taken across band earnings for individuals automatically enrolled who previously were not saving. The earnings band is taken to be £6,240 to £50,270, with an earnings trigger of £10,000 (all in 2021/22 terms).

When automatically enrolled, individuals and their employers are assumed to contribute at the minimum levels required under automatic enrolment legislation (phased in from a combined contribution of 2% of band earnings in 2012, rising to 8% of band earnings in 2019 in accordance with existing regulations) unless otherwise stated.

Limitations of analysis

Care should be taken when interpreting the modelling results used in this report. In particular, individuals are not considered to change their behaviour in response to investment performance. For example, if investments are performing poorly, an individual may choose to decrease their withdrawal rate and vice versa.

Monte Carlo simulation can be a powerful tool when trying to gain an understanding of the distribution of possible future outcomes. However, in common with other projection techniques, it is highly dependent on the assumptions made about the future. In this case, the choice of distribution and parameters of the underlying variables, the investment returns of equities, gilts and cash are important to the results.

[100] Average annual workforce churn. DWP (2010) p49

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