# Pensions Watch | Issue 27:
# What's been happening and what's on the Horizon in the world of pensions

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*With the recent launch of the ninth annual edition of the Pension Policy Institute's The DC Future Book,[1] compiled as ever in association with Columbia Threadneedle Investments, we look at the report's key findings and steps to consider if good retirement outcomes are to become the norm.*

## The DC Future Book

2023 sees the publication of yet another highly informative edition of The DC Future Book, the ninth in the series, underpinned by the Pension Policy Institute's (PPI) fiercely independent approach to defined contribution (DC) research. The DC Future Book continues to promote a better understanding of trends and themes in the UK DC pensions market and, as always, there are plenty of facts and figures to pique the interest of even the most experienced DC practitioner. So, what are the key findings of this year's research and what actions should be considered if good retirement outcomes are to become the norm?[2]

## A poor substitute for DB

The report notes the rapid decline in private sector active defined benefit (DB) participation, now at 930,000 active members. Meanwhile, active DC membership is now at 14 million and represents around 91% of private sector active pensions membership – and almost two-thirds of all actives with the inclusion of the 6.8 million public sector active members.

Having moved from a system of generous pension provision, collective passivity and certain outcomes where everything was *done* for you (DB) to one that is increasingly less generous, with individual responsibility and less certain outcomes and where everything is *down* to you (DC), addressing the inadequacy of retirement provision is fast becoming one of the UK's biggest socio-economic challenges.

Indeed, the report notes the myriad risks that fall firmly on the shoulders of both DC savers and those in decumulation, most of whom are ill equipped to manage and sidestep them – hence the very real risk of a collective sleepwalk into poor DC outcomes.

Indeed, continuing with this theme of risk, the report notes that as we are almost at peak DB pension income generation, in the absence of materially and sustainably higher DC contribution rates and stellar investment returns, DC will continue to prove a very poor substitute. And that doesn't even touch on the greater individual decision making, risk and complexity attached to DC. More on this shortly.

## Automatic enrolment

The success story, with which we're all familiar, is that more than 2.2 million employers have auto-enrolled a whopping 10.9 million people into an occupational pension scheme since 2012, with over 1 million re-enrolled.[3] Workplace pension participation has now accelerated among people aged between 22-29 from 24% in 2012 to 85% in 2021 – the largest increase among any age group. Good news indeed. However, the flip side is that the number of employees *ineligible* for automatic enrolment (AE), because of age or earnings, has been growing at

[1] The DC Future Book: in association with Columbia Threadneedle Investments. 2023 edition. Lauren Wilkinson, Daniela Silcock and John Adams. The Pensions Policy Institute. September 2023.
[2] Unless otherwise stated, all statistics referred to in this edition of Pensions Watch have been taken from the September 2023 edition of The DC Future Book.
[3] As at 30 June 2023. See: Automatic enrolment declaration of compliance report. The Pensions Regulator. July 2023.

an even more rapid rate. Consequently, for the first time ever the number of ineligible people – 10.9 million – equal the eligible. Equally worrying is that this may suggest an increased prevalence of less secure, lower paying jobs. Indeed, 171,000 of those who are ineligible are multiple job holders.

The Bill to enact the proposals from the 2017 AE review[4] – to start contributions from the first pound of earnings (up to the higher earnings band) and lower the minimum age for contributors to 18 – will ultimately materially increase eligibility, especially among young workers. However, the nation's 4.4 million self-employed, few of whom have any notable pension provision, will remain excluded. That particular elephant in the room must be the next big issue to tackle.

The success of AE is further tempered by the widely acknowledged inadequacy of the minimum AE contribution rate of 8% of *band* earnings,[5] compounded by the continued stagnation of both employer and employee average DC contribution rates around the minimum mandated rate. The PPI is not alone in believing that if the basis of a moderate standard of living in retirement is to be achieved, minimum AE contribution rates for the median earner ultimately need to be elevated to somewhere between 12% and 20% and calculated from the first pound of earnings.

However, there is the risk of significant opt outs being triggered by AE pension savers who might see this as a step too far – especially given the prolonged cost-of-living crisis. For opt out rates to not hit a tipping point, introducing the auto escalation of contribution rates[6] and the ability to opt *down* rather than simply opt out must be the way to go.

## Median DC pot sizes

Intrinsically linked to AE are median DC pot sizes. At £12,300, continued sub-par median DC pot sizes remain concerning, as is the forecast at State Pension age (SPa) at around £42,000 for those aged 55-64 today, rising to around £67,000 in 2043 (in 2023 money terms) for those currently aged 35-44. The latter, even when coupled with a triple locked full State Pension paid from age 68, would still be insufficient to sustain anything like a moderate standard of living.[7]

## Asset allocation

The PPI's annual DC Asset Allocation survey continues to grow in stature, providing us with ever greater insight into the investment strategies run by participating schemes, who collectively manage almost 37 million DC pots totalling £145.6 billion. It is reassuring to see continued healthy levels of active management and increasingly greater diversification of default fund asset mixes. However, there is still a way to go in embracing more governance-intensive and genuinely diversifying less liquid asset classes given the positive cash flow and ultra-long investment horizons of most DC schemes and members. All respondents recognised the importance of environmental, social and governance (ESG) factors in managing their schemes' investment risks, with 92% maintaining that environmental and governance factors were very important, and 75% saying social factors were.

## Accessing DC pots

Compared to pre-pandemic levels, in 2022 (the latest data available) we continued to see fewer DC savers access their DC pots for annuitisation and income drawdown, although there are hints that with lower annuity prices annuity sales might increase to pre-pandemic levels.

However, full and partial cash withdrawals continued to increase above pre-pandemic levels, possibly due to cost-of-living pressures. In Q1 2023, 50% of unadvised income drawdown customers opted for investment pathways, with the majority selecting investment strategies that align with either leaving their money invested without taking any income in the next five years (37%), or planning to withdraw all of their money within the next five years (34%). Disconcertingly, a recurring theme remains the increased numbers of those actually at retirement not seeking regulated advice before purchasing an annuity (82%) or income drawdown product (39%). Likewise, the take-up of Pension Wise guidance, which is backed by the UK government, still has a way to go. However, the mandatory stronger nudge pension providers must give to members accessing their pension pots may yet improve this free-to-access service's uptake.

## Aggregate DC assets and active DC savers

The key points here are that aggregate DC assets continue to rise and could double from today's £600 billion to £1.2 trillion in 2043, with the number of active savers increasing by 6.4% to almost 15 million, more than 70% of whom could be saving via a master trust. That £1.2 trillion is a number that could well rival the size of aggregate DB assets in 20 years' time – depending, of course, on whether well-funded DB schemes run-on or go to buyout.

[4] See: Automatic Enrolment Review 2017. Maintaining the Momentum. DWP. December 2017. https://www.gov.uk/government/publications/automatic-enrolment-review-2017-maintaining-the-momentum.

[5] The qualifying earnings band (£6,240-£50,270 in 2023/24) sets out the portion of earnings on which an auto enrolled employee and their employer have to pay contributions into a workplace pension.

[6] This so-called Save More Tomorrow approach, formulated by behavioural economists Shlomo Benartzi and Richard Thaler in 2004, originating from the same behavioural school of thought as auto enrolment, enables DC savers to commit today to paying increased contribution levels only in the event of receiving future pay rises. By not having to pay any money today, and not experiencing any reduction in their current take-home pay, the individual delays this cost, thereby better aligning it with the (seemingly far off) future benefits that will ultimately accrue. See: Richard H. Thaler, University of Chicago and Shlomo Benartzi, University of California, Los Angeles. Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving. Journal of Political Economy, 2004, vol. 112, no. 1, pt. 2.

[7] According to the Pension and Lifetime Saving Association's (PLSA) Retirement Living Standards (see: https://www.retirementlivingstandards.org.uk), as a rule-of-thumb, for a single person living in retirement in 2023 outside of London, a gross income of £12,800, £23,300 and £37,300 will respectively provide a minimum, moderate and comfortable standard of living. Based on the best RPI-linked annuity rates available today, £67K for a 65-year-old would generate an initial guaranteed index-linked annual income of £3,085. (Source: HL, 24 August, 2023). In other words, an initial amount (i.e. before annual index linking) which, even after taking the full state pension of £10,600.20 into account, is only just above that required to finance the PLSA's minimum standard of living in retirement.

## How will decumulation decisions differ for future DC savers?

Finally, the thematic chapter of this year's The DC Future Book explores the demographic and policy changes and consequent risks likely to be faced by future generations of DC savers – notably Gen Z and tail-end Millennials – at and during retirement. This will likely be the longest-lived generation that will almost certainly be wholly dependent on DC savings to supplement their income from the State Pension, which will likely be received ever later in life. This may also be the generation that, in never experiencing home ownership, has to meet the elevated costs of renting throughout retirement.

Consequently, if this generation is to achieve adequate and sustainable retirement outcomes, the provision of financial education from an early age, allied to readily accessible education, guidance, tools and support to facilitate later life financial planning, will be imperative. This also applies to the provision of innovative fit-for-purpose retirement solutions that combine elements of security and flexibility. This will necessitate fundamental change.

## Why does this matter?

As noted earlier, The DC Future Book explicitly recognises that with the shift from DB to DC, and the subsequent risk-associated impacts, addressing the inadequacy of retirement provision is fast becoming one of the UK's biggest socio-economic challenges.

Aside from being a valuable reference document and an invaluable source of DC thought leadership, informed debate and discussion, in reaching out to all stakeholders – policymakers, regulators, providers and practitioners – The DC Future Book is also a catalyst for change. In particular, the report implicitly recognises that with continued policy inaction a whole generation of people are potentially facing a worsening retirement outlook. This includes many of the nation's 4.4 million self-employed who increasingly operate in the gig economy with its meagre pensions uptake, and those 10.9 million employees likewise excluded from AE by virtue of their age and/or earnings.

Moreover, even those who do meet the AE criteria or who participate in other qualifying pension schemes do not on average save enough to generate a moderate, let alone comfortable, standard of living in retirement. This is evident from current and future projected median DC pension pot sizes. Then there are the recurrent dwindling numbers using independent financial advice when accessing their pots.

Of course, while the disproportionately central role likely to be played by the State Pension should prevent a deepening of the UK's above average old-age poverty rate, a lack of decisive action means that on current trajectories far too many people are set to unwittingly sleepwalk into retirement penury and endure, rather than enjoy, a retirement after a lifetime of work.

While the motivation and means exist to generate better retirement outcomes for today's 20-, 30-, 40- and even 50-somethings, what appears to be missing is the will to develop a better framework. Moreover, this framework could draw more extensively on good behavioural science to arrest the seemingly imminent decline in retirement living standards by helping guide people towards more optimal decisions to and through retirement.[8]

In other words, whether a basic, moderate or comfortable retirement becomes the norm is largely contingent on timely and decisive action, or continued inaction, by both the pensions industry and policymakers. The clock is ticking.

[8] See: Mind the gap: Overcoming the cognitive barriers to saving for retirement. Chris Wagstaff, Columbia Threadneedle Investments, June 2016; and Generating retirement outcomes to be enjoyed and not endured: Why we must harness the opportunities and overcome the risks at and in retirement in a world of freedom and choice. Chris Wagstaff, Columbia Threadneedle Investments, February 2018.

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