IFoA Strategy: The Future of Defined Contribution

Overview

The UK pension framework is undergoing significant reform. As of 2016 85% of defined benefit (DB) schemes were closed to new members or both new members and new accruals.[1] Yet the number of people saving into a defined contribution (DC) pensions arrangement is increasing dramatically. By 2020, over 10 million people are expected to be newly saving or saving more as a result of automatic enrolment (AE).[2] This transition from DB to DC pensions arrangements means that whilst employers remain a vital player in the pension framework, there has been a shift in longevity, inflation and investment risk from employers to individuals.

There have been two major policy responses to this transition towards DC pensions – 'Automatic Enrolment' and 'Freedom and Choice'. These cover the accumulation and decumulation phases respectively. Owing to the long-term nature of these reforms, it is unlikely we will be able to determine whether they have been a success in changing behaviours and outcomes for some time. If they have not, the effects will be exacerbated by changes in demographics, with the percentage of the UK population aged 65 years and older set to increase from 17.5% in 2015 to 23.6% by 2035.[3]

The IFoA Pension's Board has therefore developed this strategy document with the objective of addressing the questions:

- What are the issues and what questions do we need to address?
- What role should the IFoA play in shaping the future of DC pensions?

This strategy identifies those aspects of the DC environment where the IFoA should contribute to legislative, regulatory and behavioural developments and provides a framework for delivery.

The starting position is to promote good outcomes that are in the public interest. **We have defined a good outcome as not running out of money in retirement.** Whilst this sounds like a simple objective, it involves successfully mitigating a number of complex risks and navigating a series of complex financial decisions.

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[1] Pensions Policy Institute (2016) *The Future Book: Unravelling workplace pensions, second edition 2016*

[2] Gov.uk (2016) *Press release: New figures show that by 2020 over 10 million people are expected to be newly saving or saving more as a result of automatic enrolment*, 13 October 2016 [Available online: https://www.gov.uk/government/news/the-number-of-people-saving-as-a-result-of-automatic-enrolment-to-hit-10-million]

[3] Office for National Statistics (2017) *Overview of the UK population: March 2017* [Available online: https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/articles/overviewoftheukpopulation/mar2017]

We believe there is a clear role for actuaries in ensuring the DC framework achieves good outcomes.

What are the issues and what questions do we need to address?

There is a vast amount of literature on the changing face of UK pensions; a particularly comprehensive review is the Pension Policy Institute's 2016 '[The Future Book: Unravelling workplace pensions, second edition 2016'](#).

Worryingly it concludes that:

"With the relatively recent shift to individuals making key saving and investment decisions for themselves, the evidence so far suggests that many households will be unable to maintain their current standard of living when they reach retirement."

To overcome this there needs to be a review of how much people are saving, and how they are then turning those savings into an income.

Saving for retirement

Who will be saving into a DC pension?

In the UK, it is estimated that of the 38 million people of working age, around 11 million are not saving enough for their retirement.[4] AE has successfully increased the number of people saving into a workplace pension. Around half of the working age population is eligible for AE and opt-out rates are low.[5] Based on this, by 2030 we estimate that circa 45% of the working age population will be automatically enrolled into a workplace DC pension. This flags two important questions for policymakers in terms of DC coverage:

- **Who is opting out?** If as a result of opting out these individuals are at a higher risk of not saving enough should the Government consider some form of compulsion?
- **Who is not eligible?** The 2017 Review of AE acknowledges that eligibility should be increased and proposes steps that the Government could take to increase the proportion of workers who are eligible for AE. The Review also identifies potential solutions for those who are self-employed, and therefore currently outside the scope of AE.

The IFoA will continue to monitor the progress of AE and will have a reactive strategy here, providing input to relevant Government and industry consultations / initiatives.

Will people be saving enough?

The initial AE contribution rate of 2% (1% from the employer and 1% from the employee) means that whilst more people are saving, the median pot size has started to decrease. The minimum contribution is set to rise to 8% (3% from the employer and 5% from the employee)

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[4] Department for Work and Pensions (2012) *Estimates of the number of people facing inadequate retirement income*

[5] Pension Policy Institute (2017) *PPI response 'Review of automatic enrolment – initial questions'*

by 2019. This level of contribution is unlikely to provide a sufficient level of income for everyone, even if they have a full contribution history.[6]

This raises the question how do we get employees saving more? There are a number of potential responses:

- Increase the minimum contribution?
- Introduce a form of auto-escalation akin to 'Save for Tomorrow'?
- Improve member engagement and encourage saving?

In reality, it is likely that a combination of these will be necessary. Because of the potential complexity, and the likelihood that one contribution rate will not be appropriate for everyone, and not at every point in their life.

This is an area where the IFoA can add a valuable contribution as so we will consider what proactive analysis we can undertake to contribute to this debate.

Harnessing inertia

Having unengaged savers is not a new phenomenon; in traditional trust-based schemes, the employer took responsibility for driving contribution levels. However, since the introduction of AE there has been a sizeable growth in use of master trusts.[7] Master trusts are able to serve multiple employers and create economies of scale – most of these are passively managed and have lower charges than other DC schemes.

- Is the increase in master trusts in the member's best interests?
- What are the pros and cons of scale and is the regulation of master trusts sufficiently robust?

Half of master trusts report that 99% of their membership is invested in the default fund.[8] The prevalence of large default funds created by AE provides the opportunity to harness inertia to benefit members. There is a range of investment strategies for default funds amongst different providers, with some schemes proving to be far more conservative than others in their de-risking strategy in the approach to retirement. This must be considered against the backdrop of the reducing number of people seeing retirement as a 'cliff-edge', often continuing to work into older age.[9]

- Are current default fund investment strategies appropriate in the current environment?

This is an area where the IFoA can add a valuable contribution as so we will consider what proactive analysis we can undertake to contribute to this debate.

[6] IFoA (2014) *Outcomes and Defined Ambition,* The Defined Ambition Working Party [Available online: https://www.actuaries.org.uk/documents/outcomes-and-defined-ambition]
[7] House of Commons (2017) *Master trust regulation,* Briefing Paper No CBP-07758, 20 January 2017
[8] Pensions Policy Institute (2016) *The Future Book: Unravelling workplace pensions, second edition 2016*
[9] Office for National Statistics *Five facts about… older people at work, 1 October 2016* [Available online: http://visual.ons.gov.uk/five-facts-about-older-people-at-] work/

Improving financial capability

Whilst harnessing inertia will undoubtedly remain an important part of the DC environment, as individuals have greater responsibility in managing the risk of not saving enough, we believe that improving financial capability must be a priority. Recent IFoA research has found low levels of engagement amongst those with low and middle incomes and those in young and middle ages.[10] Those with low incomes are unlikely to benefit from engagement and be reliant on the State and younger savers are unlikely to engage until their savings accumulate to an amount that seems 'worthwhile'. However the lack of engagement amongst those with middle-incomes and in middle ages, who are arguably in a position to take positive action to save enough, is concerning.

IFoA research suggests that if a person focuses on outcomes (i.e. the level of income they are going to need in retirement) and understands the impact of under-saving on their quality of life they will then be better able to focus on their target level of saving. This will mean they can monitor progress towards this target and, where possible, take action to achieve this during their working life. We also found that individuals would be more likely to engage in financial decision making if they believed their efforts were likely to be worthwhile.[11] One way of demonstrating potential risks and rewards of financial decisions would be to provide a projection of the individual's retirement income based on current assets and savings relative to their retirement income goals.[12]

The incoming pensions dashboards will undoubtedly be useful tools, but without infrastructure that helps individuals to firstly understand the information being presented, and secondly to understand what this means for their retirement planning, they are unlikely to have any significant impact.

- How do we create a comprehensive communication strategy that targets those who stand to benefit most from engaging, and how do we build their financial capability over time to ensure their engagement is meaningful?

We have started to build on our earlier outputs on adequacy and leveraging the momentum gained by others also giving this greater attention. We have a policy briefing in production of how Retirement Income Goals might be incorporated within the current pensions environment and the Participation, Accumulation and Decumulation Working Party is also scoping a project on what level Retirement Income Goals might be set at in a DC world.

[10] *add reference once published on 12 October*

[11] IFoA (2014) IFoA (2014) *Outcomes and Defined Ambition,* The Defined Ambition Working Party [Available online: https://www.actuaries.org.uk/documents/outcomes-and-defined-ambition]

[12] IFoA (2015) *Policy briefing: Saving for retirement* [Available online: https://www.actuaries.org.uk/documents/saving-retirement-policy-briefing]

The State Pension

Whilst occupational and private pensions will be crucial for many people, the first pillar of the UK pensions system is the State Pension and this is vital for the majority of pensioners to secure an adequate income in retirement. In fact it accounts for roughly half (51%) of pensioners income on average in England.[13] There are three policy levers that impact the State Pension – the level of income it is set at, the method for uprating the State Pension and the State Pension Age. The new State Pension was implemented in April 2016, the triple-lock will likely remain in place until 2020 and the Cridland Review of State Pension means that increases in State Pension age increases until 2039.

A survey in 2016 by the IFoA, American Academy of Actuaries and Australian Institute found expectations of receiving a State Pension decrease with age across the three countries – from 81% of the oldest cohort, 65% of the middle aged cohort and 53% of the youngest cohorts expecting to receive a State Pension. It may be that younger cohorts are concerned that a State Pension may not be available for them when they reach retirement.

This is an important area, but one where the opportunity to influence is not immediate and so we will review our activity on the State Pension in late-2018.

Turning savings into a retirement income

What is happening now?

The FCA's Retirement Outcomes Review Interim Report published in July 2017 showed a number of worrying trends:

- A high prevalence of early access (before age 65);
- A transition from annuities to drawdown;
- Decisions being made without shopping around or seeking advice;
- Limited product innovation. [14]

Those currently accessing DC pensions are likely to have small pots and alternative DB provision providing them with security of income in later life. Therefore, we are not recommending that policy changes are made based solely on current behaviours. However, the Review's findings suggest that we need to gain greater understanding of the likely behaviours of younger cohorts who will approach retirement with a greater, if not complete, reliance on DC pots.

The prevalence of early access coupled with a transition to drawdown ring alarm bells in the context of our key objective for the pensions framework: not running out of money in retirement. The combination of early access and lack of a secure income until death increases the likelihood that these individuals will run out of money in retirement, and worryingly this will be in the latest stages of retirement, when they are least likely to be able to take remedial action (e.g. return to work).

[13] Pensions Policy Institute (2017) *PPI Pension Facts, June 2017* [Available online: http://www.pensionspolicyinstitute.org.uk/pension-facts/pension-facts-tables]

[14] Financial Conduct Authority (2017) *Retirement Outcomes Review Interim Report, July 2017* [Available online: https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf]

This transition is affecting the retirement income market. The FCA's Review reveals there are only seven providers still offering annuities on the open market. Moreover, the pensions freedoms have done nothing to overcome the behavioural biases that stop people from shopping around. As was and remains the case with annuities, consumers are not shopping around for drawdown products either.

As a greater volume of consumers with sizeable DC pots approach retirement the DC market will have to innovate. These might include 'hybrid' solutions, which combine an element of annuitisation with the flexibility drawdown offers. NEST has already published a blueprint for how this might work in practice, though a recent review concluded that NEST should not enter the decumulation market at present.[15]

Here, as with the saving phase a multi-layered approach will be needed if the DC market is going to deliver a sustainable pension system that promotes adequacy of income. Again, we would assert that those with middle-incomes are particularly at risk. Those with low incomes are likely to rely on the State Pension and those with large DC pots are more likely to have other personal savings and a financial adviser to assist. It is those in the middle for whom financial advice may be perceived as too expensive or poor value for money, and they will therefore be more reliant on information and nudges from product providers and guidance services when deciding what to do with their savings. If individuals are going to understand the options available to them then we need to improve financial capability as these decisions are complex. Again, this should be targeted at those who stand to benefit most from engagement and seek to build financial capability over time, staring before retirement.

This is an area where the IFoA can make a valuable contribution. We have published a policy briefing on a sustainable level of drawdown and the potential for hybrid-options that combine drawdown and annuitisation. We would like to develop a series of analysis to further the evidence base on a range of solutions for managing longevity risk in DC.

Demographics

In all of this, we cannot forget changing demographics. Not only are more people becoming DC savers, but there will also be more people in retirement than ever before. The population over 75 is projected to double in the next 30 years.[16] This means if we do not get it right a large burden will be placed on future generations and there is a risk of higher levels of pensioner poverty.

What role should the IFoA play in shaping DC pensions policy?

The changing UK demographics coupled with the growth of DC mean that a comprehensive strategy for future retirees is needed. AE is a successful first step, drastically increasing the number of people saving into a pension, but evidence suggests they are not saving enough.

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[15] Department for Work and Pensions (2017) Consultation Outcome – *NEST: Evolving for the future* [Available online: https://www.gov.uk/government/consultations/nest-evolving-for-the-future]
[16] Office for National Statistics (2015) *National population projections for the UK, 2014*

Freedom and Choice has created space for market innovation, but the behaviours of those currently using the freedoms give some cause for concern.

To have a pensions framework that meets our objective of ensuring that people do not run out of money in retirement we consider there are two main themes where the IFoA can meaningfully influence policy, regulatory and industry developments:

- **Adequacy** – of savings, State provision and of income in retirement
- **Understanding and mitigation of longevity risk** – there is a role for guarantees and the pooling of risk as it is impossible to know any one individual's lifespan

Our strategy will focus on delivering an evidence base that enables us to develop clear and engaging messages on the following:

- **DC contribution rates** required to provide adequacy
- **Clear information on life expectancy** and on the importance of taking life expectancy into account in planning for the future
- **Options for managing longevity risk** such as the role of default strategies, hybrid-solutions that offer an element of guarantee, as well as other options for pooling longevity