

Outcomes And Defined Ambition

the Defined Ambition Working Party

March 2014

Authors:

Adrian Boulding
Jerry Edmondson
Gillian Foroughi

Sandra Graham
Tessa Page
Alan Ritchie (Chair)

Please note: this paper is designed to aid discussion, views expressed are those of the working party and not necessarily of the Institute and Faculty of Actuaries





Please note: They say a week is a long time in politics - and it really can be. Just at the point of publishing this paper, the Chancellor and then the Minister of State for Pensions announced some high impact changes relating to pensions savings. For example, to introduce new flexibility in the way the pension can be taken at the point of retirement, to cap pension charges for qualifying schemes and to ban various features such as active member discounts. A next step for this paper will be to update it given the various changes announced and to consider these in relation to our proposals for six key themes to close the savings gap.

Contents

1. Focusing on outcomes – defining the ambition	4
2. Recent success in addressing the pensions challenge	11
3. Current position with the pensions challenge	13
4. What outcomes to target	20
5. Member case studies	26
6. Better engaging customers	31
7. Pension design challenges (including “soft” and “hard” guarantees)	49
Appendix – assumptions for case studies	55

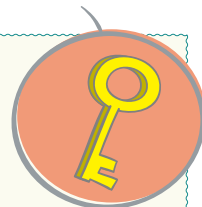
Disclaimer

The views expressed in this publication are those of invited contributors and not necessarily those of the Institute and Faculty of Actuaries. The Institute and Faculty of Actuaries do not endorse any of the views stated, nor any claims or representations made in this publication and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this publication. The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this publication be reproduced without the written permission of the Institute and Faculty of Actuaries.

1. Focusing on outcomes – defining the ambition

Key points

- ⦿ It's the outcome that matters – delivering an adequate income in retirement. We need to get the focus back to outcome management
- ⦿ We recommend six steps to reinvigorate retirement provision in the UK and a timeline that stretches from now to 2020
- ⦿ Following the success of early auto-enrolment we should continue to work with the grain of human nature and “nudge” people towards a good retirement outcome.



We are pleased to produce this paper shortly after the launch of the DWP's consultation paper on Defined Ambition (DA)¹. We share the Pensions Minister's enthusiasm that we can do much more for savers than many of today's Defined Contribution (DC) schemes with default contribution levels and default investment funds do. As the DWP paper shows, Defined Ambition is a multi-faceted topic and we hope that our paper, with its strong outcomes focus, can be seen as a contribution to unfolding Government thinking in this area.



Summary

Ever since the cost of final salary schemes started to attract shareholder concern and Finance Directors became interested in pensions the focus has been on inputs. Commentators have been looking at the size of pension contributions and wondering, variously, whether people can **afford** them or whether they are paying enough. The transition to Defined Contribution schemes, and legal requirements for the inclusion of fringe workers like part-timers and temporary staff, served to draw attention even more closely on the contributions we're all paying.

This paper shows how switching the focus back to outputs can help to deliver adequate pensions in retirement for the mass of employees and restore faith and trust in an industry through providing greater clarity over the state of people's retirement savings. There is so much concern around whether people are paying enough in, what level of charges are being taken, hidden fees that are a drain on performance and highly complex tax rules that some people are even ready to give up on pensions. Our six steps to rescue retirement provision and get it back on track are:

1 The staging of auto-enrolment needs to be completed on time. The story so far has beaten all expectations, with over 90% of employees remaining in active membership after being auto-enrolled². The staging schedule, which for employers of 50 lives or less stretches out after the next General Election, will bring in significant numbers of new retirement savers by 2018. This step should remain as the must focus on this as a first priority, without distraction from any of the many other potential changes that are currently in the spotlight.

2

Move the focus away from inputs (contributions, investment performance, expenses) and onto outputs. We must concentrate our minds on what level of retirement income an individual needs and whether they are on track to achieve it. Focus on inputs in isolation can be damaging and can encourage negative media attention such as allegations of “rip off charges”³. These risk both undermining confidence in retirement savings (reducing the ‘contribution’ input) and driving providers to offer lower quality solutions (reducing the likely outputs). Focus on outputs would encourage market improvements around inputs (e.g. if expenses are too high or investment performance too low, then output will suffer). It would also raise the profile of consumer engagement by encouraging higher contributions towards saving.

3

Strong independent governance is needed to achieve the holistic view across all the facets of a pension scheme without getting distracted by short-term focus on inputs that may reflect immediate public opinion. Achieving members' retirement goals should be the focus of attention of the governance body.

4

“Pot follows member” (for small pots) has the potential to transform the landscape that individuals inhabit. Instead of an individual pension being a series of disconnected islands, arising from discrete periods of work, “pot follows member” can bring these together into one more substantial landmass that generates member interest and more control of decision making.

5

Auto-escalation should follow on from auto-enrolment. This will “nudge” savers gently along from the initial low entry contributions up to levels that can deliver the pension they need. It has the potential to harness those same behavioural traits that auto-enrolment has so successfully been built upon.

6

Finally we need guarantees. Once members have built up a worthwhile stock of retirement savings – the product of the previous five steps – they will have something worth protecting. Once they have better engagement with their outcomes, they will be more likely to consider paying for them at a level that makes their provision viable. The IFoA has worked with the grain of insurance since its inception and is well placed to contribute to the debate over what shape and form new pension guarantees should take.

Our recommended timeline looks like this

	1	2	3	4	5	6
	Auto-enrolment staging for existing employers	Shift focus to Outcomes	Independent Governance	Pot follows member	Auto-escalation	Guarantees
Now	↓	↓	↓			
Q2 2014	↓	↓	↓			
Q4 2014	↓			↓		
2016	↓			↓		
April-17					↓	
2019						↓
2020						↓

Shifting from the current focus on inputs

The introduction of auto-enrolment has been predominantly through DC schemes. The law stipulates the minimum contribution and many companies, especially those facing a significant increase in pension scheme membership, have understandably been busy calculating how much extra cash they will need to stump up for pension contributions in the near term.

Similarly, there’s been a huge focus recently on expenses – charge caps, charge structures, commission⁴. The problem is that there are some schemes offering poor value for money for consumers. The solution being debated is how charges can be reduced. This can be beneficial for customers if that solution doesn’t result in watering-down the resulting pension provision for schemes currently offering good value for money (better results for less than proportionately higher costs).

So we’ve taken our eye off what’s really important. Whilst focusing on the inputs like contributions and expenses we’ve been ignoring the very thing we’re saving for, namely an adequate income in retirement. That’s what we must concentrate on. We believe that strong independent governance is best placed to do this, without being distracted by short term issues of the latest political hot potato.

Building consumer interest

Members too have an important role to play in keeping their own pension on track. This will require considerably more member engagement than we have seen to date, and a level of understanding much higher than auto-enrolment will bring. Working with another of the basic tenets of human behaviour, we believe that people become more engaged with things that are tangible and large enough to look important⁵. The Coalition Government’s initiative “pot follows member” is an important way of achieving this and a key milestone along our path. It does two things – bringing diverse bits of pension entitlement together makes them both tangible and appear larger. The size limit that applies to automatic transfers would need to be a delicate balance between transferring enough pots together to coalesce into a large one whilst not automatically moving a large pot where the detriment of transferring to an inferior scheme could be painful.

Continuing the important Auto-enrolment initiative

Existing employers complete their “staging”, their introduction to auto-enrolment, on 1st April 2017. Newly created employers since 2012 will also have staged by early 2018. A statutory review of auto-enrolment is scheduled for that date, and many voices⁶ are already calling for that to address the issue that the low levels of mandatory contributions – 8% of qualifying earnings is just not enough. We believe that the solution is another behavioural technology “wheeze”, auto-escalation, to gently nudge people up to adequate levels.



The recent stochastic modelling by Pensions Policy Institute⁷ shows that without an outcome focus some people may retire on half the pension they need whilst others may retire on two or three times what's comfortable. The former will be hard up in their retirement years whilst the latter may feel they could have spent more on their family during their working life. We note the balance isn't currently 50/50 here, and that "over-savers" are in the minority with today's average pension pot used to purchase an annuity producing income of just under £2,000pa⁸.

More confidence in the outcome

Unless we turn the focus to outputs we are vulnerable to the Achilles heel of DC pensions – the variability of outcomes between members. An employer can install a scheme with generous contributions, sensible investments and low charges but still find that, in the absence of an outcome focus, staff retiring this year may get a pension very different from the level enjoyed by people who retire only a few years before or after them. Those who get much less than others are likely to feel aggrieved.

So as pension entitlements build up, members will have something worth protecting. The final step on our time line is then a new form of guarantee. It must offer a reassurance to members that the outcome volatility can be managed, and at the same time bear witness to the fact that employers' financial resources available to pick up the slack are now at a rather lower level than was the case when employers began down the final salary road.

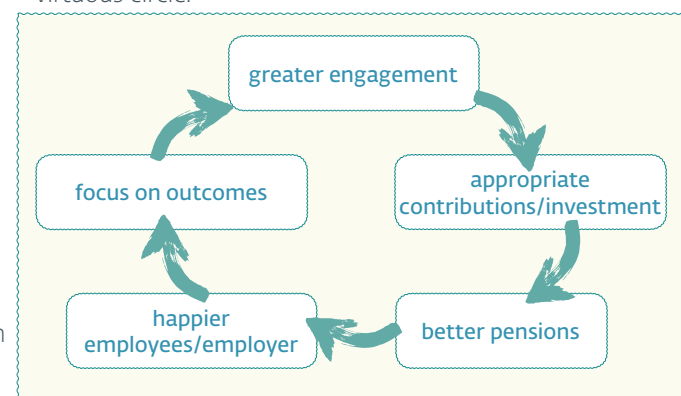
These new pension guarantees are what many people have come to associate with the term "defined ambition". But this paper argues that they are just one of the steps along the road to an outcome focused pension system. As the level of funds already accumulated, and so in need of protection, is currently low, this paper concentrates on the other important steps that come before guarantees on our timeline.

Outcome driven engagement

Moving the focus to outcomes is a big shift of emphasis, and the time to do it is now. If we delay then some consumers may have been blown too far off course by the deflection of unseen ill winds, which can come in the shape of missing contributions, stock market falls, high charges or deteriorating annuity rates. It is worth noting along the way that we believe the order of importance of these factors is first contributions, then investment, then decisions on retirement income and lastly expenses.

An outcome focus will look to bring greater engagement and higher levels of personal responsibility. If employees know and understand their target outcome, then they are in a position to monitor it and take corrective action. Moreover, if those corrections are made soon enough then small but frequent alterations should be needed enough to keep the ship on course.

Greater engagement in turn leads to employees placing a higher value on their pension, in which case it can make business sense for employers to help out with matching contributions to a higher ceiling when that is necessary⁹. And in turn as people achieve their goals the savings gap will close, reliance on the State help will fall and people will be in a position to choose more appropriate retirement income streams, such as an increasing annuity in place of a level one to alleviate the risk of erosion by inflation. It's a virtuous circle.



We can see a number of spin-off benefits from this focus on outcomes and greater employee engagement:

- ⊙ Consumers will better understand the importance of having both a good State pension and a good private pension. This may reduce the risk of future political interference with State Pensions such as the reductions in SERPS that were implemented by the Thatcher and Major Governments of the 1980s and 1990s
- ⊙ Employers will be held more to account by their staff for the progress of pension savings
- ⊙ Employers will also benefit. The employer will be less likely to have issues with under-funded workers having to stay well past their expected retirement to afford their lifestyle with detrimental consequences to business performance¹⁰
- ⊙ The "buyer side" of the market will strengthen, leading to greater consumer pressure on pension providers. This will address a concern raised by OFT that the buyer side of the DC workplace pension market was one of the weakest that they have seen, which they attributed in part to a lack of employee engagement¹¹
- ⊙ Employees will be more willing to consolidate pensions from past jobs in one place for better monitoring, supporting DWP initiatives like "pot follows member"
- ⊙ Thinking ahead to Defined Ambition guarantees, their value will become more apparent to employees seeking to lock in gains, and they will become more viable for providers as people become willing to pay the real cost.

How to focus on outcomes

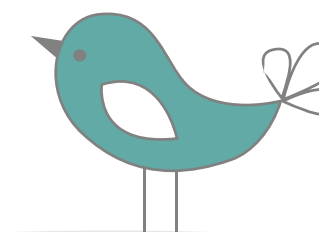
It won't be easy to change the habits of all participants in the pensions industry to focus on outcomes rather than inputs. However, it should be possible with sufficient and consistent messaging.

This will work best if led by the DWP, supported equally by all other key stakeholders – notably employers, trustees, pension providers and intermediaries.

The first step would be for all DWP's consultation papers to focus on outcomes – both in content and in the way ideas are communicated. It could also be powerful if the DWP continued its advertising campaigns for auto-enrolment and used this as an opportunity to introduce a focus on outcomes.

Intermediaries and pension providers can then help employers and employees consider the impact on outcomes through the information they provide.

Employers and Trustees will arguably have the greatest influence on the success of any corporate scheme communications and indeed any other initiative in this paper. One missing ingredient to date has been how to help consumers determine the right level of income to target. In Chapter 4 we propose a method to do this and in Chapter 5 we illustrate this with two hypothetical case studies.



Recommendation

The DWP should be rightly proud of its Automatic Enrolment initiative and other pension reforms in recent years. We have to address the savings gap issue in the UK and the steps taken so far have been invaluable. We must complete auto-enrolment and not do anything that would put success of this at risk. Other change should be pursued at the same time but with a clearly defined focus on the short list of initiatives that optimise member outcomes – too much attempted change at once leading to substandard delivery and too much of an inputs focus at the expense of the outputs that really matter are the biggest risks to success in closing the UK's savings gap.

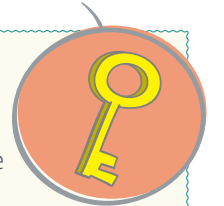
This paper is a timely call to action. By focusing on outcomes we can harness consumer power and move to a world of improved retirement incomes without the excesses of either pure Defined Benefit (DB) or pure DC. With the term "Defining the Ambition" we want employees to understand their destination and, with the help and support of their employer, progress smoothly to their target.



2. Recent success in addressing the pensions challenge

Key points

- Auto-enrolment, state pension reform and a greater focus on DC governance have all been positive steps towards a better financial future for retirement savers. It is crucial that these are completed without delay
- This gives us a great platform for further change required to build a sustainable, fit for purpose system.



As introduced in the previous section, there is a lot happening in UK pension provision.

Most notably, the shift in workplace pension provision from a voluntary to quasi-compulsory regime through the introduction of auto-enrolment was recommended in the 2006 Government white paper. The Pensions Act 2008 introduced the basic provisions and framework, followed by a series of consultations, a formal review by the Coalition Government, through to implementation, with auto-enrolment for the largest companies starting in October 2012. Its introduction will be rolled out gradually up to 2018.

1: Reshaping workplace pensions for future generations, Department for Work and Pensions, November 2013

2: What level of pension contribution is needed to obtain an adequate retirement income? Pensions Policy Institute, October 2013

3: DWP Research Report 854 published in 2013 showed the opt-out rate averaged just 9%.

4: Daily Telegraph 22nd January 2014 article on rip off pension charges including a quote from speech by Pensions Minister to CBI conference that he is "committed to clamping down on rip-off pension charges"

5: OFT Market Study on DC Workplace Pension, DWP Consultation on Workplace Pension Charges, IMA Enhanced Disclosure on Fund Charges, Labour Party promise in February 2014 to cap pension charges if they form next Government

6: Origo comments included in Government response to DWP Consultation "Improving Transfers and Dealing with Small Pension Pots" published by DWP 17 July 2012

7: Debate at NAPF Annual Conference 2013 reported in The Actuary 18th October 2013

8: Figures presented by annuity provider Legal & General to ILC Debate "Are annuities fit for purpose" at House of Lords 30th January 2014

9: CIPD Employee Outlook Report Winter 2010-11

10: Research by Hymans Robertson published in a press release on 25th June 2013 showing that two thirds of employers believe that almost half of their workforce will be unable to afford to retire at State Pension Age and that over a third say this will negatively impact on productivity

11: OFT Defined Contribution Workplace Pension Market Study findings, first published September 2013 and then revised in February 2014



In general, opt-out rates (that is, the proportion of eligible employees choosing to leave their scheme after being automatically enrolled) have been lower than expected¹². There have been some high profile success stories, for example, McDonald's Restaurants has seen only 2.4% of its hourly-paid employees and 2.7% of its salaried staff that were auto-enrolled in January 2013 opt out¹³. Admittedly, the examples to date have been larger employers, many of which have undertaken targeted communication exercises in conjunction with the roll-out.

We might therefore tentatively conclude that inertia works – the low opt-out rates are encouraging, and auto-enrolment is a great start towards building a better retirement savings culture in the UK. That said, we note that smaller employers may face greater challenges.

Other factors could impact auto-enrolment success – such as potential increases to personal tax allowances, which would be expected to exclude more people from participating in workplace schemes. Hargreaves Lansdown has estimated that raising the allowance to £12,500 could exclude up to three million people from auto-enrolment¹⁴.

State pensions are also undergoing reform. At the core of the Pensions Bill 2013-14 is the introduction of a flat-rate state pension for anyone reaching retirement age after April 2016. The new, non-means tested state pension will be £144 a week at today's prices for all those who reach state pension age and have 35 years of National Insurance contributions. The state pension age is also changing, rising to age 67 for men and women between 6 April 2026 and 5 March 2028.

Again, there are reasons to cheer here – under the new rules, stay at home parents and the self-employed will be recognised, and simplification in itself may help individuals

to plan more easily for retirement.

Away from these two significant changes, more subtle shifts in pension policy and provision are afoot – the focus on charges for DC schemes, The Pension Regulator's increasing emphasis in DC (e.g. the quality features of a good DC scheme), the FCA investigation into the annuity market, removal of compulsory annuitisation, etc.

However, subtle is not going to be enough to crack the pension conundrum, we really do need a new approach to get more individuals to think about their retirement planning. A system designed around outcomes, including Defined Ambition, lies at the heart of this but these are big changes and there is a risk that practical steps are lost within the scale of the ambition. Our six steps offer a measured, "real world" solution.

3. Current position with the pensions challenge

Key points

- ⊙ Average contribution rates for DC savings schemes are less than half those of DB schemes and remain too low to generate an acceptable standard of living in retirement for the majority
- ⊙ The public is uninspired by retirement saving and the industry has been damaged by scandals and poorly governed, high cost legacy schemes. Trust must be restored and improved Scheme Governance will play a big part in this
- ⊙ Nudge theory has a crucial role to play in solving some of these challenges; notably auto-escalation to build up from very low contributions and "pot follows member (for small pots)" to help consumers feel they have "skin in the game".



A common problem

Governments of developed nations everywhere are trying to respond to the financial challenges posed by an expanding older generation. If workers could save more for their retirement it would relieve some of the pressure on state benefits in the future. Sadly, in the UK and many similar economies, employees' savings fall well short of what they will need for a comfortable retirement.



¹²: www.tapassist.co.uk/averageautoenrolment-opt-out-rate/

¹³: www.professionalpensions.com/professional-pensions/analysis/2277193/they-re-loving-it

¹⁴: The source is: https://www.usdaw.org.uk/adviceresources/pensions/news/2014/january_personalallowancecouldinre.aspx

When employers offered generous final salary based schemes, saving through work was very attractive, and generally seen as part and parcel of having a job. However, the rising cost of these DB schemes has forced companies to close them to new entrants and in some cases further benefit accrual. The DC schemes which have replaced them have much lower total contributions. We discuss this further later in this section. Furthermore, the low levels of DC contributions have not increased in line with longer life expectancy. Deteriorating economic conditions and the need to pay down personal debt have also acted as a hindrance to savings levels.

There appears to be little appetite for a solution that makes pension contributions compulsory. The Government is therefore looking at new and creative ways of designing and communicating pensions that might increase total contributions.

The attack is on many fronts, including better education, auto-enrolment and the flat rate state pension as noted in the previous section.

The Pension Minister's DA proposal means different things to different people. However, at heart it is a new way of thinking about the retirement savings that is intended to encourage continued membership and higher contributions by better defining the benefits savers can expect from their contributions.

The idea is that under the DA framework there is a proliferation of competing designs that each makes the pension provision more sustainable for the employer than under DB but also more certain for the member than under DC. In this context "more certain" seems to have two potential meanings, either "more transparent" or "more closely defined". DA therefore attempts to tackle both the apathy caused by members not understanding the benefits they will get from their DC pensions, and also the fear of investment that the lack of DC guarantees might cause.

We would also expand the concept to cover an approach to inspiring and communicating with individuals about retirement savings that focuses on outcomes.

This paper proposes our vision of what defined ambition could look like in practice.

Before doing so, we summarises the key challenges.



We aren't saving enough

Auto-enrolment is taking place overwhelmingly into DC schemes. Whilst such schemes may offer the opportunity for adequate retirement incomes, at current average contribution rates, they do not.

The examples in Section 5 illustrate that 8% contributions to a DC pension are not enough, even for a worker contributing for 40 years at this level and even after allowing for expected state benefits. This assumes no break in contributions and a retirement age of 68. This highlights that contribution levels for auto-enrolment schemes (and DC schemes in general) are simply too low. Under auto-enrolment legislation, contribution rates will start at 1% each for the employer and employee and rise to 3% and 5% respectively by 2018¹⁵. There is a danger that these rates become seen as "correct", potentially lulling individuals and employers into a false sense of security.

Outside auto-enrolment schemes, average contribution rates are not significantly different, at 2.7% for employees and 6.2% for employers (source: Office of National Statistics Pension Trends, 2012 Edition); 8.9% in total. For defined benefit schemes the average rates are 5.1% for employees and 15.8% for employers, excluding special contributions; 20.9% in total. In summary, defined benefit scheme members' benefits, on average, are funded by c. 2.3 times the level of contributions that defined contribution members are. Radical steps are required in order to avoid a lost generation of retirees.

Auto-enrolment will also exclude many, most notably the unemployed and self-employed.

The state pension reform clarifies what level the "safety net" that it provides will offer, but alone this cannot realistically be considered to provide the standard of living that most individuals seek.

Value for money

The recent stepping up of pressure on pension providers, consultants and fund managers to be more transparent about cost (and to reduce these where possible) is welcome. Perceived high charges are one of the aspects that risk turning the public away from pensions.

Ensuring that charges are not overly high should be at the heart of future pensions policy.

The consultation on capping charges is welcome in order to delve deeper into this issue, but such an approach may have unintended consequences and we would caution against adopting a policy that may feel intuitively positive for savers without fully considering the downsides.

In reality, it is "value for money" that is needed, rather than a race to the bottom on charges. A modestly higher fee arrangement that provides better member outcomes (e.g. through strong governance, risk-focused investments and engaging communications) will always be favourable over a lower cost option with weak governance, high risk and limited communication with members.

Charges are just one aspect of value for money (see Section 4). Whilst charges are easier to assess and compare than "value", we should not grab the easy option but instead retain the outcomes (net of all costs) focus.



Risk is on the individual

DC schemes also place all investment risk before retirement with the scheme member. Often this is not understood, and the investment and annuity conversion uncertainty that such schemes provide makes planning for retirement difficult. It is reasonable to understand that employers (including the public sector) are cautious of any tilt back towards “DB for all” which became expensive and burdensome from a regulation perspective. We should at least step back and consider whether the sharp transfer of all risk to the individual needs reassessment.

We return to this later in Section 6.

Understanding and behaviour

There remains too a fundamental gap in individuals’ understanding of what and when they need to save, and indeed how much they should be “targeting” to live on in retirement.

Indeed, this is where we believe that the Defined Ambition concept has most value to add; as introduced in Section 1, to date, scheme provision has been “input based” with the focus on setting a contribution structure, investment options and some literature support, rather than focusing on the “outcome” - the level of real income that individuals can expect in retirement. This is a subtle point but a critical one and forms the central thesis of our paper.

The lack of understanding is not helped by the current method of communicating individuals’ “investment pot” (in a DC context at least) throughout the pre-retirement phase. An investment pot of say, £100,000, may feel like a substantial sum, and often the conversion rate (and the risk associated with it) is not grasped. Although let us not get ahead of ourselves; the average DC investment pot, after commutation, used to buy an annuity in 2012 was actually only £33,455.¹⁶

However it would be wrong to suggest that communication difficulties would vanish if the investment proposition was designed around levels of retirement income. Whilst the industry has looked hard at alternative ways of communicate an expected but uncertain income, it continues to aim too high in terms of the mass market’s understanding of probabilities and how savings are converted to income. Anxious to avoid being subject to future claims and/or blamed for not articulating the downside risk clearly enough when made a scape goat for bad future investment experience by Governments and/or the media, the industry has moved towards including too many confusing, ‘small-print’ caveats.

Communications at present are also typically snapshot based – “this is what you have”. Enabling individuals to take positive action would improve matters – for example “click here to increase your chance of meeting your ambitions.”

There is also evidence that the “nudge” theory can be helpful in this regard, such as Save More Tomorrow/ auto-escalation schemes. We have seen through auto-enrolment that take-up rates are encouragingly high to date. However, what is remarkable is not just that the level of pension scheme membership has beaten expectations, but that the proportion now voluntarily engaging in saving for their future is higher than other walks of life achieve for compulsory behaviours. Compare the 90% to 95% pension rate with compulsory rear seat belts (achieving just 88% according to The AA Seat Belt Report) and the law on mobile phones in cars which only 19% of us comply with, according to a recent survey by goodmobilephones.co.uk.

Professor Shlomo Benartzi of University of California, Los Angeles has taken auto-enrolment a step further with auto-escalation. Documented studies for his “Save More Tomorrow” programme in the United States show that where people make a commitment to increase their pension contributions in the future, similarly high levels of participation can be achieved. The key to the programme is that the increments should be small compared to pay increases and the timing should be linked to the individual’s pay review cycle, so take home pay doesn’t fall as pension contributions increase.

In the UK, the Department for Work and Pensions took a small number of employers through the same exercise of auto-escalation around ten years ago and found the same behavioural traits work over here too. Both the US and UK results were influential in the Pensions Commission’s recommendation for “phasing” auto-enrolment, which is now enshrined in legislation. In two steps, the minimum employee contribution rates will rise from 1% to 3% on 1st October 2017, and then to 5% on 1st October 2018. Taken with a minimum employer contribution rate (which varies by earnings definition), this means at least 8% of band earnings or 9% of basic pay being contributed to pensions after 2018.

But these levels are not enough (e.g. see the stochastic modelling of pension outcomes published by the Pensions Policy Institute in October 2013).

We believe that auto-escalation has an important role to play in getting people to save enough to deliver their target pension. But we may need to be more clever than just carrying on the statutory “phasing” and increasing the minimum 8% until we reach the 12% that, for example, Australia has legislated for or the 15% called for by the National Association of Pension Funds.

Early analysis of the auto-enrolment opt-out data suggests that employers who have set minimum contribution rates above the 1% level have experienced higher opt-out rates than those who have started on the bare statutory minimum. This fits with the behavioural technology traits described above – people will go along with long term saving if the level of immediate sacrifice is not too great.

The implications for auto-enrolment are already worrying. After 2018, anyone entering the system, perhaps because they have reached age 22, their earnings have reached the £9,440pa trigger or because they have been auto-re-enrolled after three years, will start at a 5% employee contribution, not 1%. And if we increase the statutory minima beyond that their starting point will be even higher. The resulting impact on their first wage packet after joining the pension scheme may prompt high levels of opting-out.

An alternative solution would be to require all qualifying pension schemes to operate a system of auto-escalation. On first joining the scheme, employees would be auto-enrolled at a suitably modest contribution level, but put on notice that their contributions will increase in small steps each year until they hit the statutory minimum.

Whilst this could lead to job-changers seeing a reduced pension contribution for a few years, the long term benefits of keeping 90% to 95% of people in the system would outweigh both this and any additional administrative burden for the pension schemes.

By using auto-escalation in line with the rules of behavioural technology we can help more people achieve their target outcome.

Developing 'skin in the game'

It has been said¹⁷ that an individual only starts to really care about their pension savings when it reaches the value of their annual salary. The "Pot follows member"¹⁸ concept for small pensions fits with this theory – helping consumers build one larger pot rather than several small ones that they don't notice. It should also help consumers on smaller salaries or who move jobs often to get better value for money from their savings – and improve the economics for product providers at the same time.

This initiative is therefore to be applauded and works well with expected behavioural biases. However, implementation should be carefully designed so as not to be harmful to those with larger pots moving to lower quality schemes.

Building trust

Too often, pensions are seen as a "product" that is optional and viewed with suspicion. Various 'bad news stories' over the years (e.g. Equitable Life's demise, endowments mis-selling, examples of DB scheme failure) have contributed to this. Looking ahead trust in the system is vital to ensure "buy in" to a savings culture.

Media spotlight on the industry is welcome to raise awareness, and a questioning press has a crucial role to play. However, the tone and sensationalist nature of some pensions reporting (e.g. the way pensions charges were reported in October 2013 in the context of possible caps) is unhelpful and the relentless negativity does not bode well for future generations.

Of course, developing faith in robust Governance would help rebuild trust and pension scheme governance has been a hot topic during 2013, particularly for Defined Contribution schemes. The Pensions Regulator set out six principles and thirty three features that trustees can look for to determine that their DC pension scheme is of good quality. These are now embraced within TPR's Code of Conduct 13, which became effective in November 2013.

The Office of Fair Trading's market study into DC workplace pensions published its findings in September 2013. They concluded that:

- ⊙ A weakness on the buyer side of the market coupled with a high degree of product complexity meant that competition alone could not be relied on to deliver good consumer outcomes.
- ⊙ The governance of pension schemes should be improved in order to improve ongoing scrutiny of value for money on behalf of scheme members.
- ⊙ Contract based schemes were a concern, where the OFT found a lack of independent governance and that more often than not, those carrying out governance functions were responsible to the insurer's Board and shareholders and lacked any fiduciary duty to the members.

Gregg McClymont, Labour's shadow Pensions Minister raised the question "Who is looking after the members' interests?" He has proposed amendments to Pensions Bill 2013 that would require all pension schemes to have a board of independent trustees, although so far these have not been taken further by Parliament.

These various calls for better governance have met with little resistance. Apart from some evidence that large schemes are often better governed than small schemes, there has been pretty much universal acceptance that pension fund governance, particularly DC rather than DB, needs to improve. And as these moves get put into practice the theme of this paper is very timely.

Combined with more focus and interest being placed on pensions by the employer as sponsor, independent governance can help rebuild trust.

Governance must ultimately focus on providing good outcomes. Members join and contribute to schemes to provide for their retirement years. Those governing pension schemes must therefore concentrate on providing members with the tools to understand what outcome they require, and then seeking to deliver the level and type of benefit that members as a whole might reasonably be hoping to achieve (accepting that there will always be uncertainties around individual members' needs).

For many trustees and advisers, this means a move away from looking at the inputs. The contribution rate, the investment performance, the expense deductions and the annuity purchase are not goals in themselves but rather parts of a complex and evolving process that lead towards the generation of a secure retirement income.

Moving towards a system where the outcome is the primary focus will enable us to see these component parts not in isolation but in terms of how they relate to each other. Rather than looking at expenses and declaring that "cheaper is better" we should look at value for money and measure how the services being paid for will deliver facets that contribute to the achievement of the goal. And whilst we would like all pensioners to buy at the best possible annuity rate, viewing their circumstances in the light of their contributions may direct schemes with typically lower fund levels towards a panel type solution rather than individual advice and broking for each member.

Trustees or scheme governors cannot feel satisfied with a tick in the box against most of the input parameters. It's a pension that their members want, and that's the outcome to be monitored to declare a scheme is successful.

Timing of initiatives

Auto-enrolment and state pension simplification are great starts, but there is much to do. In this paper we outline proposals for pension design and communication changes. Importantly, an order needs to build that allows the introduction of changes in a logical order, rather than attempting a single "big bang".

In particular, the focus on outcomes needs to come before product design issues. Without such an approach, weighing up the pros and cons of guarantees and structures which provide them will struggle to gain traction.

Any Change professional will champion that a series of smaller projects have much greater success rates than one very large project (think Edinburgh trams, Solvency II).

Auto-enrolment is a great example of a significant change being segmented into smaller implementations over a stretching but realistic timeframe. Even with staging dates spread out, there is growing concern of a provider "log-jam" with the larger platform providers struggling to cope with demand¹⁹. The burden on employers to establish appropriate administration and payroll systems and communicate with their employees has also been large.

Furthermore, phased implementation allows time to stop, look and listen along the way. We should not be afraid to question whether initial plans remain fit for purpose.

Our report identifies long term solutions that would cover at least two parliamentary terms, recognising the political realities and potential barriers to success. If delivered, we will be able to look back in 2020 having achieved a huge amount for the benefit of UK consumers.

¹⁶: Link to detailed rules.

¹⁷: ABI: Retirement Choices: Baseline to Measure Effectiveness of the Code of Conduct, May 2013.

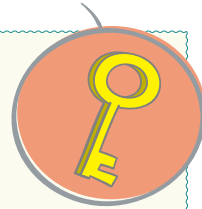
¹⁸: Corporate Adviser, The Big Question, June 2012 <http://www.corporate-adviser.com/news-and-analysis/opinion/the-big-question/the-big-question/1052865.article>

¹⁹: <http://www.ftadviser.com/2013/12/17/pensions/personal-pensions/auto-enrolment-capacity-crunch-to-hit-earlier-than-feared-4iFDt2duTFRDgwLKBYdMIK/article.html>

4. What outcomes to target

Key points

- Consumer engagement on defined contribution pensions is hampered by a lack of effective communication around helping individuals understand their retirement income needs
- Consumers find it hard to understand what their target outcome should be
- We recommend a way of defining target outcomes that can help build engagement.



Impact of auto-enrolment and flat-rate state pension

The Pensions Commission report of 2004 recommended replacement ratios which have been quoted by DWP, based on updated salary levels as follows:

Table 1 Income bands (gross earnings) and replacement rate targets		
Original 2004 income band	Income band in 2012 earnings terms	Target replacement rate
Up to £9,500	Up to £12,000	80%
£9,500 – £17,500	£12,000 – £22,100	70%
£17,500 – £25,000	£22,100 – £31,600	67%
£25,000 – £40,000	£31,600 – £50,000	60%
Over £40,000	Over £50,000	50%

Source: Reinvigorating Workplace Pensions, DWP, November 2012

For an individual on a median salary of £21,000, these figures are consistent with the outcomes of defined benefit schemes which typically targeted two-thirds of final salary. However, in the context of defined contribution, replacement ratios are not particularly helpful. Indeed, if this individual contributed to a typical auto-enrolment scheme for 40 years and had a full entitlement to the flat-rate state pension, the level of income in retirement would vary from about 50% to 80% of the recommended amount²⁰. So for a typical individual, the solution currently being promoted stills falls some way short of providing what is widely regarded as an acceptable level of retirement income.

Currently, for a typical person, private provision only accounts for about one-third of retirement income with state benefits accounting for the largest proportion. In 2011/12, DWP found that 88% of pensioners had income over and above state benefits²¹. The following table shows the sources of income for pensioners over time:

Source of pensioner income	1994/95	2011/12
Benefit income	48%	43%
Occupational income	25%	27%
Personal pension income	1%	4%
Investment income	12%	7%
Earnings	13%	18%
Other	1%	1%

However, this could change over retirement depending on how each component grows. Although there is currently provision for the flat-rate state pension to increase annually, it would be expected that over 90% of auto-enrolled pension pots will be used to purchase an annuity with over 90% of these being a level annuity. Without good quality advice to guide individuals at retirement, it is likely that over time, the value of the retirement income will be eroded.

Whilst charges have been in the spotlight recently, and are a factor in determining end outcomes, other factors are much more significant in affecting retirement income levels. The following table shows the approximate make-up of pension retirement income based on two different scenarios by age and investment return assumption (consistent with the scenarios used as Case Studies in Section 5 – Joe and Mary):

	DC pension - scenario 1	DC pension - scenario 2
	40 yrs to retirement ("Joe" in Section 5)	20 yrs to retirement, £30k initial pot ("Mary" in Section 5)
Make up of base case		
Contributions as % of total	44%	58%
Investment return after charges as % of total	56%	42%
Sensitivity vs Base Case		
Investment return + 1% pa	23%	14%
Contributions + 2% pa	25%	18%
Annuity cost + 10%	-10%	-10%
Charges + 0.25%pa	-5%	-3%

Source: own calculations

The reality of the situation is that, in practice, the outcomes are likely to be worse than typically illustrated due to opt-outs and incomplete contribution records. Both NEST and other auto-enrolled schemes have reported early opt-out rates of less than 10% in general but have acknowledged that they are much higher for some schemes. The highest opt-out rates are expected amongst employees of smaller firms which are yet to be auto-enrolled – and rates are expected to increase when minimum contribution levels go up in 2017 and 2018. Further, many workers take career breaks due to family responsibilities. The following table shows the impact of variations for a typical earner on a median salary over a possible 40 year career (consistent with “Joe” in Section 5):

Contribution record (EEE + EER)	Yearly Income at Retirement (inc. State pension)	Replacement Ratio at retirement	Replacement ratio reduction	Yearly Income in today's terms (inc. state pension)
Full contribution history at 8% of salary	£32,100	47%	0%	£12,000
Take benefits 5 years early	£28,800	42%	5%	£10,700
Delay joining by 10 years	£28,400	41%	5%	£10,600
Miss 15 years of contributions, starting yr 6	£27,100	40%	7%	£10,100
Miss 25 years of contributions, starting yr 11	£24,900	36%	10%	£9,300
State Pension only	£20,100	29%	13%	£7,500

Source: own calculations

Further, when determining minimum contribution levels for auto-enrolled schemes, the criteria itself exempts the first part of an individual's earnings²². For employers seeking the perceived cheapest option of 'qualifying earnings' when calculating contributions, rather than 'basic earnings' or 'total pay', the effect is to reduce the replacement rate by about 5% over 40 years (as included in the table above).

As well as being worse for members' savings pots, using band earnings definition can be a false economy for employers due to the extra administrative requirements it can bring.

Addressing uncertainty and understanding

The provision from any auto-enrolled scheme carries a high degree of uncertainty. In a DC scheme, the member fully carries

- the investment risk which is borne both during the accumulation phase and at the point of converting the pension fund into an annuity, and
- the longevity risk that could lead to substantial changes in annuity prices before the point of purchase.

Both of these are poorly understood by the population at large. The average person does not have any understanding of the conversion factor for turning a pension fund into an income for life. Further, most people approaching retirement have given no thought to how many years retirement they might need to finance whilst those that have tend to understate their own expected longevity²³ which makes annuities look like poor value for money.

A fundamental lack of understanding of the workings of pensions and annuities creates a funnel of doubt for the member about the wisdom of contributing to a pension at all. This uncertainty has helped drive the discussions on Defined Ambition pensions and the possibility of incorporating some type of guarantee into a defined contribution arrangement.

But if this lack of understanding is so wide spread, it suggests that the current means of educating and communicating pension issues is simply not effective. Introducing another aspect to the already diverse pensions arena runs the risk of confusing matters even further unless ways can be found to make communications more engaging.

A better outcome?



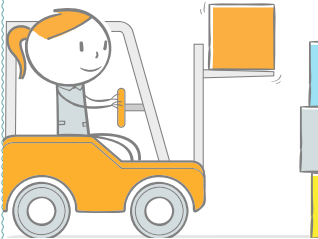

In the first instance, the most obvious way to ensure a reasonable level of future retirement income is to minimise opt-outs, and to convince people that the earlier they start saving the better. The second stage involves persuading people that the minimum is not enough and they should be looking to do more if they want a lifestyle in retirement which is relatively comparable to the one achieved pre-retirement.


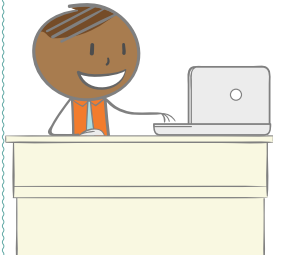

Convincing people of the need to save more today to provide for themselves tomorrow is in itself a challenge. People's natural instinct is to delay any action which will result in them being worse off²⁴. However, as mentioned earlier, there has been some success overseas with 'nudging' people to 'save more tomorrow'²⁵ whereby members are encouraged to invest (a portion of) future pay increases into their retirement savings. In the USA, around 60% of schemes have adopted the idea. In some schemes, contribution rates of those enrolled in the programme have increased by up to 4 times in as many years when the scheme is promoted in conjunction with a personal consultation with a financial adviser.

This means that people need communications that are appealing and encourage engagement. The IFoA's Consumer Information paper²⁶ promoted targeted communications rather than 'one size fits all', using tiered information to address individual's needs and wants.

The Pensions Commission report of 2004 recommended benchmark replacement rates which varied by earnings. DWP revalued the scale to current earnings levels²⁷ and we have applied it to typical earnings for seven job families.

The following table takes this information on replacement ratios and restates it in a way which is more meaningful for individuals. We propose that such a table could be used to help consumers target an outcome in retirement.

	Occupation	Current earnings before tax	Suggested Pension (in today's terms)
	Typist Call centre operative Gardener Cleaner Catering worker Care home staff	£250 to £300 a week	£210 a week
	Agricultural worker Bus Driver Dustman Construction worker Lab Technician Clerical worker	£300 to £400 a week	£250 a week
	Nurse HGV Driver Estate Agent Prison Officer Carpenter Machine Operator	£400 to £550 a week	£325 a week
	Midwife Electrician / Plumber Optician Driving Instructor Journalist Hotel Manager	£2,000 to £3,000 a month	£1,600 a month

	Occupation	Current earnings before tax	Suggested Pension (in today's terms)
	Train Driver Pharmacist Police Sergeant Teacher Architect Construction Site Mgr	£3,000 to £4,000 a month	£2,100 a month
	Dentist Healthcare Professional IT Project Manager Production Manager Purchasing Manager Personnel Director	£45,000 to £60,000 a year	£26,000 a year
	Doctor Solicitor Airline Pilot IT Director Sales Director Mining / Oil Executives	£60,000 to £80,000	£35,000 a year

For an individual at the bottom of Job Family 3 on a median salary of £21,000pa, contributing to a typical auto-enrolment scheme for 40 years and with full entitlement to the flat-rate state pension, the level of income in retirement would be about 70% of the recommended amount¹⁴.

So for a typical individual, the solution currently being promoted stills falls some way short of providing what is widely regarded as an acceptable level of retirement income – although it is a great start to the change required.

19: Own calculations, see Appendix for assumptions. Figure varies depending on annuity shape chosen.

20: DWP, July 2013: the Pensioners' Income Series

21: By £5668, in the 2013/14 tax year

22: Institute for Fiscal Studies, November 2012: Expectations and experiences of retirement in defined contribution pensions

23: Behavioural economists refer to this as 'loss aversion'

24: Thaler and Benartzi

25: Transforming Consumer Information, Nov 2011: <http://www.actuaries.org.uk/sites/all/files/documents/pdf/wpconsumerinformationfinalnovemberupdate.pdf>

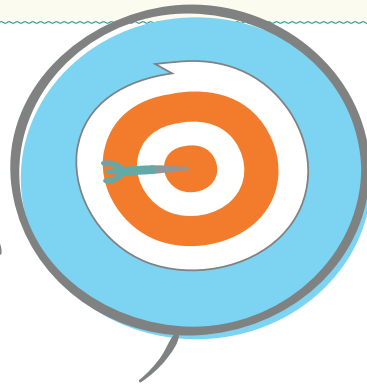
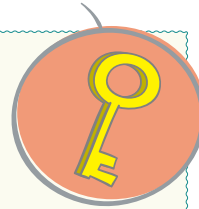
26: DWP, November 2012: Reinvigorating Workplace Pensions

27: Own calculations, assuming full 8% contributions from outset, a 5%pa nominal growth rate, with price inflation of 2.5%pa and individual earnings inflation of 3%pa. Range varies depending on annuity shape chosen and earnings definition used.

5. Member case studies

Key points

- Helping members understand their estimated outcomes can highlight much more easily the action they need to take
- In Joe's case, it helped him decide to increase contribution levels early enough for a small change to make a significant difference
- In Mary's case, it helped her consider her finances as a whole and understand the choices she has to make now to reach her desired standard of living in retirement
- The cases show the relatively high importance of contribution levels and investment returns as the two most influential factors determining outcomes.



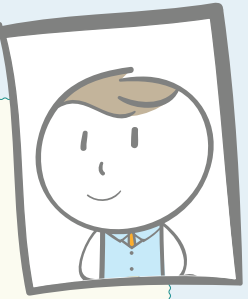
Taking the target ratios from Section 4, we now look at what it might mean for two examples and how an outcomes focus may enhance their chances of reaching their retirement goals.

The examples are hypothetical and designed for illustrative purposes.

To simplify our examples, we have assumed these individuals retire on a given date (state pension age) and take all their retirement income (including state pension). In practice many individuals will take a phased approach to retirement, for example working part time whilst drawing some of their pension income.

Case Study 1: Joe the Machine Operator

Meet Joe. He's 40 years away from retirement and has just started his job as a machine operator. His salary is the median in the UK, £400pw (£21,000pa), and he expects this to grow slightly ahead of inflation (3% vs 2.5% pa). He has no current pension savings but will earn his full state pension. Between Joe and his employer they will contribute 8% of his band earnings to a DC pension.



Joe's target income

Since Joe is a machine operator, he falls under the category in Section 4 that targets a pension in today's terms of £325pw (or £17,000pa).

Joe's Expected Outcome versus Target	
+ State Pension	£144pw
+ DC Pension	£86pw
= Total	£230pw
🎯 Target	£ 325pw
⬇️ Estimated Shortfall	£ 95 pw (29%)

Joe's outcome focus

Let's assume that the various influencers in Joe's life regarding his pensions saving (e.g. employer, government, pension provider) have helped him focus on his expected outcome versus target. Of course there are various assumptions in coming up with the extent of the difference, but by simplifying the presentation to something like the information above, it is obvious to Joe that he is not saving enough.

His options can then be presented to him. For example:

- 1 Save more:** Increasing savings rate by 1% now, allowing for your employer's 1% matching, will reduce your estimated shortfall to £74pw (23%). Increasing by 3% (assuming employer matches) would reduce the expected shortfall to £31pw (10%).
- 2 Retire later:** Planning to retire 3 years later could reduce your shortfall when you do take your income to £65pw (20%). Planning to retire 5 years later would reduce the shortfall to £41pw (13%). These values assume you reinvest the state pension you earn between your state pension age and your retirement date.

The third likely option would be to consider a different investment strategy. In all the calculations above, we have assumed a fixed investment return after charges of 4.5%pa.

Another investment strategy may have higher charges, but a higher-still expected return.

The challenge for our industry is how we might reflect, consistently, different investment options without bias or making the message overly complex. (See <http://www.actuaries.org.uk/events/one-day/sessional-research-event-transforming-consumer-information>)

One way to do this might be to introduce simplified stochastic output at this stage, such as another option:

3 A) **Invest differently:** If you change your investment selection to a risk fund level 4 rather than level 3, your chance of achieving your goal increases by 25%. Your chance of achieving less than shown above also increases, by 15%.

Or to say something like:

B) **Invest differently:** If you believe another fund will return more, after allowing for charges, this could reduce your shortfall – albeit with a risk of increasing it if the alternative investment fund performs worse than your current fund. For example, if you believe you can earn an extra 1%pa, after charges, in a different fund it could reduce your shortfall to £75pw (23%).

Joe could also be reminded at this stage that any other savings he has can be used to fill the gap. This could be option 4:

4 **Build other savings:** For example, if you can save £233,000 outside of his pension over the next 40 years (£87,000 in today's money), this will be approximately equivalent to the gap in your retirement income.

As a result of this information, Joe decided to increase his contributions by 2% and took a mental note to consider his options again in a few years.

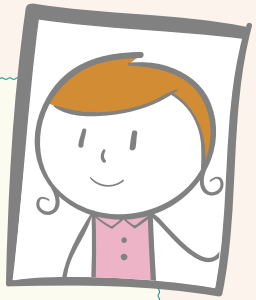
Importance of Pensionable Pay Definition

It's worth noting here that if Joe's employer had used the basic earnings definition, rather than band earnings definition, for pensionable pay, the higher contribution levels would have reduced the expected shortfall substantially. E.g. to £49pw (15%) before any action and increasing contributions by 1.5% (including employer matching) would have effectively eliminated the expected shortfall.



Case Study 2: Mary the IT Project Manager

Meet Mary. She's 20 years away from retirement and has been working as an IT Project Manager for many years. She is about to be automatically enrolled, having saved £30,000 in previous employments – spending some of this time as a self employed contractor. Her salary is £50,000pa and she expects this to grow slightly ahead of inflation (3% vs 2.5%). Mary will earn her full state pension. Between Mary and her employer they will contribute 9% of earnings to a DC pension (the minimum requirements since they're using the basic pay definition for pensionable earnings).



Mary's target income

Since Mary is an IT Project Manager, she falls under the category in Section 4 that targets a pension in today's terms of £26,000pa.

Mary's Expected Outcome versus Target		
+	State Pension	£7,500 pa
+	DC Pension	£9,500 pa
=	Total	£17,000 pa
⊖	Target	£26,000 pa
↘	Estimated Shortfall	£9,000 pa (35%)

Mary's outcome focus

Like Joe, Mary has been influenced to be very outcomes focused and appreciates the estimates of where she might be versus her target. It helped Mary having a target to aim at as she would have found it very difficult to come up with one for herself. Mary had previously felt that £30,000 as a pension pot wasn't too bad, but with an outcome focus and a target to aim at is now shocked at her situation.

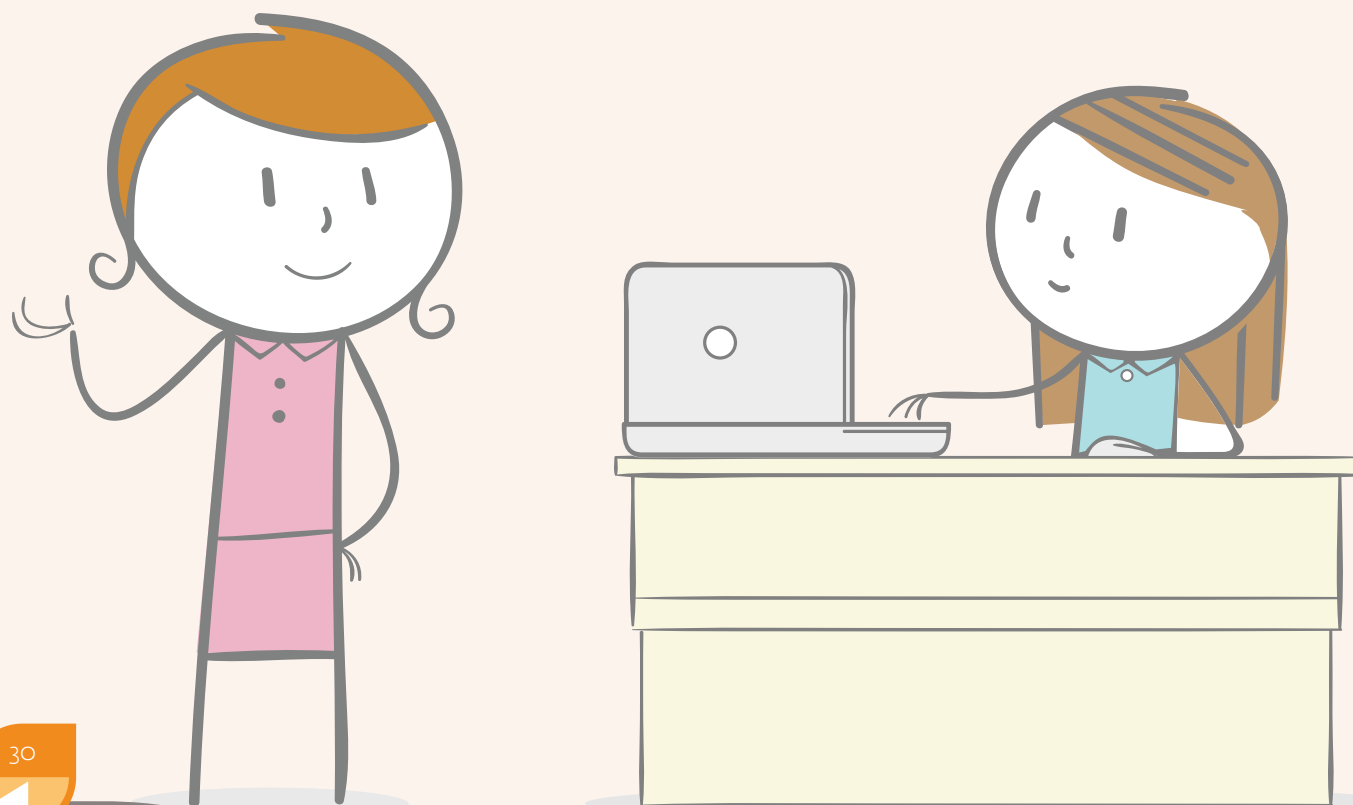
Her options might then be presented to her as:

- 1 Save more:** Increasing your contribution rate by 1% now, allowing for your employer's 1% matching, will reduce your estimated shortfall to £7,500 pa (29%). Any contributions above this won't be matched by your employer. To effectively eliminate the expected shortfall, you would need to increase your contributions by 10% of salary – from 5% to 15%.
- 2 Retire later:** Planning to retire 5 years later could reduce your shortfall when you do take your retirement income to £3,000pa (12%). This assumes you reinvest the state pension you earn between your state pension age and your retirement date.
- 3 Invest differently:** If you believe another fund will return more, after allowing for charges, this could reduce your shortfall – albeit with a risk of increasing it if the alternative investment fund performs worse than your current fund. For example, if you believe you can earn an extra 1%pa, after charges, in a different fund it could reduce your shortfall to £7,800pa (30%).
- 4 Build other savings:** If you save £258,000 outside of your pension over the next 20 years (£157,000 in today's money), this will be approximately equivalent to the gap in his retirement income.

As a result of this information, Mary appointed a financial adviser. With her help, she ear-marked the £70,000 equity she had in her property to support her pension requirements in the longer term. She also increased her contributions by 3%pa, which increased her employer contributions by 1%pa. This effectively eliminated her anticipated shortfall, albeit she knew she would need to release the equity in her home if she wanted the target level of income at retirement.

Mary decided to keep a close eye on how her estimated shortfall progresses over time, paying close attention to the regular communication from her employer and product provider.

She may well seek further advice over the years – especially as she approaches retirement and wants to optimise how she takes her income (e.g. drawdown vs. annuity).



6. Better engaging customers

Key points

- ⦿ Better engaging customers requires a significant change in the way retirement planning is communicated
- ⦿ 'Traditional' attempts to turn people into pension experts have generally failed because underlying behaviours haven't changed
- ⦿ To get people taking action, communication must be about:
 - Context, not content
 - Outcomes, not inputs
 - Engagement, not education.



Blind ambition

Perhaps perversely, 'Defined Ambition' is not particularly clearly defined at all.

To the knowledgeable industry insiders, it is clear it's about sharing risk and 'known unknowns' more fairly between employee and employer and that there are lots of different ways to do this:

- ⦿ Guaranteeing a fixed pension pot on retirement
- ⦿ Paying a guaranteed pension income
- ⦿ Giving employees an estimate of what pension they will receive, based on a wide range, and that range being narrowed down as they approach retirement.

Hardly a uniform view but there is a common theme, and this is about improving the certainty of the member's outcome.

That's important because, in the wider world, understanding is far less well-informed and certainly no less indefinite, but real people (i.e. members) by and large don't care about risk sharing; they do value improved certainty.



The 'traditional' approach to communicating pensions and engaging members has offered certainty: Defined Benefit members know what pension income their membership will generate and Defined Contribution members know how much their membership will cost.

However, traditional pension communication has not enabled members to know the single most important piece of information in the context of retirement planning: how much they are actually going to need.

This is partly because traditional pension communication has focused almost exclusively on the 'mechanics' of how schemes work. Understandable given the unavoidable requirements of Disclosure and Compliance but focusing on what has to be communicated rather than what members need to know hasn't turned the UK into a nation of pensions experts.

When you're starting out on a long car journey, it's more important to know where you need to go and how you can get there than it is to know how the engine works.

In pension communication terms, members are interested in, and want to know about, what kind of income they're going to need when they retire, how close they are to achieving it and what they have to do if that's not likely because none of this is intuitive. They're not so interested in the fine technical scheme design detail because the scheme design is just a means to an end: a car engine for that long drive.

When people lack confidence in the quality and volume of knowledge they possess on any given subject, a typical reaction is to seek advice or guidance from expert opinion. In the context of pensions, members turn to scheme literature looking for an answer to their most basic question 'what should I do?'

The challenge is that's the last thing they will find in Compliant and Disclosure-meeting communications. Lots of information and lots of facts, but no guidance, no advice.

The way people are psychologically wired doesn't help.

Consider research carried out by psychologists Christopher Chabris and Daniel Simons²⁸ which demonstrates the power of a psychological bias called 'inattention blindness'. Put simply, this is the tendency for most people to miss or ignore information of a certain type 50% of the time when they are looking for information of a different type.

The potential implication for pension communication is that, 50% of the time, the information carried simply doesn't register because it's not really what the member is looking for (i.e. guidance). This would go some way to explaining the sustained low levels of member understanding around the mechanics of pension schemes despite that being the focus of traditional pension communications.

But the truth is that members generally don't know what they don't know or aren't told, and they are generally not told what kind of income they should be targeting.

63% of employers don't think employees are saving enough money to ensure adequate income in retirement.

67% believe that more than 2 in every 5 employees will be unable to retire at scheme retirement age due to having inadequate pension savings.

HR Directors and Decision Makers Survey
(24-30 April 2013, Populus)



Not knowing this creates risk (for employees and employers) because it's knowing what they should be targeting (and how far off that hitting target they are) that creates the impetus for members, not necessarily to become pensions experts, but to take action; to do something that will help avoid a bad outcome – being unable to afford to retire.

If the objective of reducing the State provided element of overall retirement income to 1/3rd is to be achieved, Defined Ambition has, as a minimum, to provide exactly that: a clear, consistent and relevant idea of what a member needs (or should target) as a retirement income.

If you do what you always did, you'll get what you always got...

From 2014, children across all schools in the UK will learn about personal finance after changes to the national curriculum brought England more in line with Wales, Scotland and Northern Ireland where personal finance is already taught.

Perhaps this will lead to future generations being more comfortable with some of the basic principles that underpin saving for retirement such as risk and reward before they enter the workforce.

In the meantime, however, we need to look at how to help those already saving towards retirement because simply continuing with the traditional, information and Disclosure/ Compliance focused approach to engaging members has not worked and there is no indication that it will suddenly start doing so.

Better engaging people with retirement saving will mean fundamentally reconfiguring the way pension communication is designed, developed and delivered and adopting this new approach.

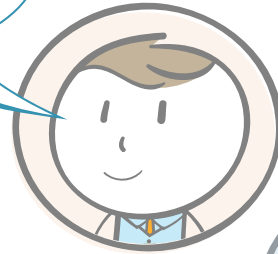
There are 4 key dynamics to consider:

- 1 Context, not content:** enabling members to look at retirement savings in terms of hitting a target that's relevant to them, rather than simply contributing as much as they can (or not)
- 2 Outcomes, not inputs:** focusing members on how 'good' their outcome looks by expressing benefits in terms of how likely they are to hit the retirement income target
- 3 Engagement, not education:** enabling members to understand their options and take control of their retirement saving, without feeling they need to be pensions experts
- 4 Inspiration, not information:** motivating members to actually do something.

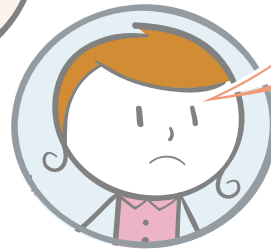


Context, not content:

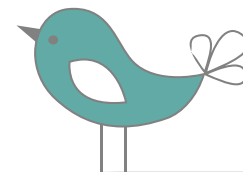
I'm in a DB plan so I know what pension I'm going to get and that means I'm going to be fine, right?



I'm in a DC plan so there's no way of knowing what kind of pension income I'll get, so it's just fingers crossed right?



I've got a really good idea of the sort of retirement income I should be targeting.



In the heyday of DB, members not only had the general notion that a pension of 2/3rds pay at retirement was a good 'target', employment patterns meant there was a fair chance of achieving it.

This 'rule of thumb' no longer holds true. The proliferation of DC means that whilst members clearly see what they are paying in to their schemes, they have relatively little idea of how that will translate into retirement income and absolutely none in terms of how that will then stack up against the income replacement ratio they should be targeting. Even the broad-brush 'to get a decent pension, you should be contributing at half your age' is non-specific in terms of outcome.

Only 18% of DC members have any idea of what kind of income they will need when they retire.

57% are not confident they will receive an adequate income in retirement.

Current UK Adult (DC) Pension Members Survey
(19-25 March 2013, Opinium)



Perhaps counter-intuitively, DB members also suffer from this lack of context. Although the retirement income from an individual membership is more clearly defined, this is seldom if ever expressed as a function of target retirement income and the trend towards increasingly fragmented employment patterns means that even those fortunate enough to still be accruing DB benefit shouldn't necessarily believe they are automatically going to have a retirement income that meets their needs.

So the problem is that without a specific context, it's very difficult for members to have any clear idea of how well (or not) their saving for retirement is actually progressing.

There's little value in asking people what sort of income they want in retirement – they simply don't know.

There have been a number of initiatives attempting to enable members to set their own retirement income targets. These have often involved interactive modellers which ask members to identify those elements of regular household expenditure they imagine they will still have after they stop work.

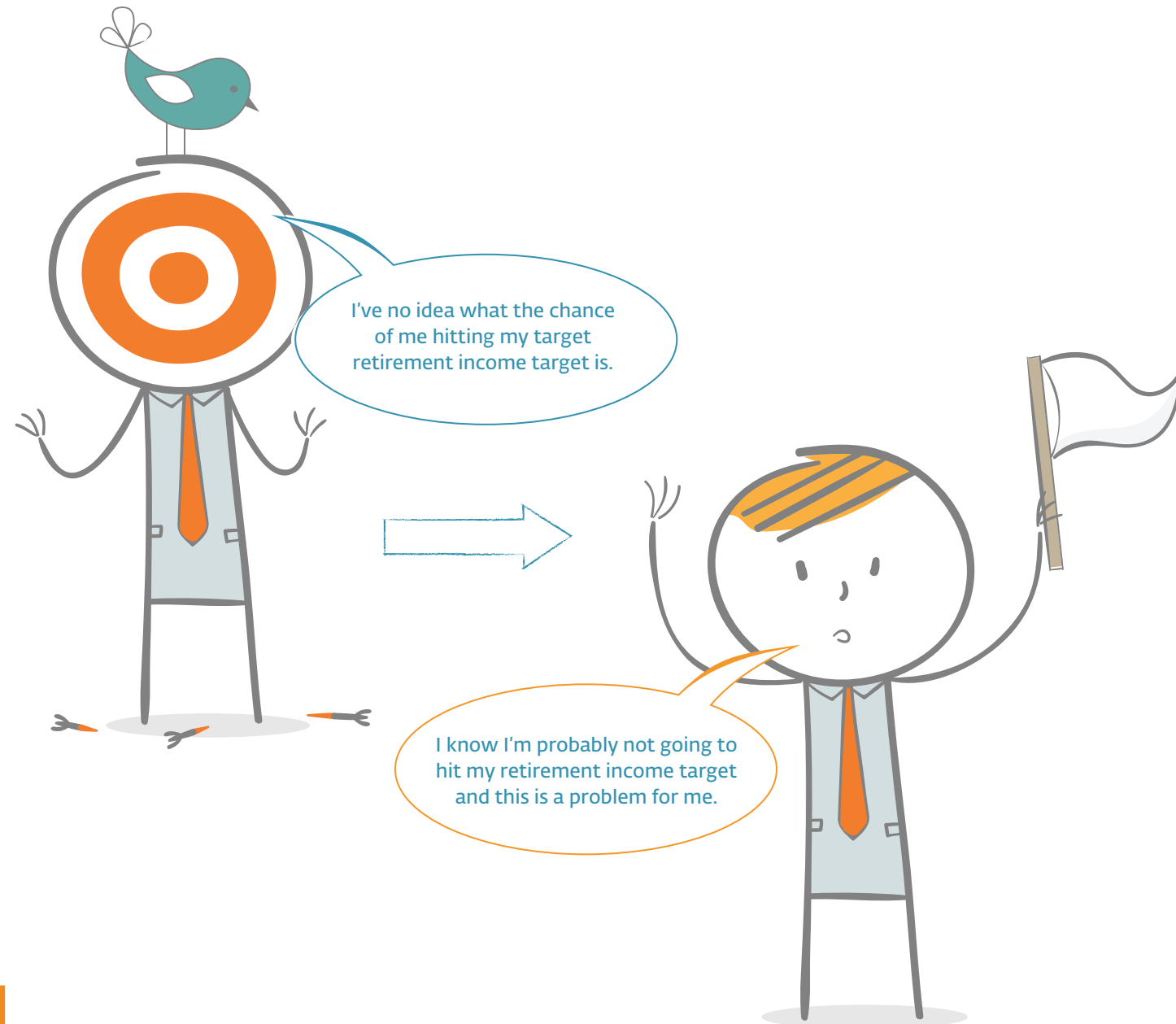
Feedback on the effectiveness of such modellers is patchy but the fact is that they still require members to make something of a logical leap because they lack a definitive benchmark upon which they can base their thinking.

Simply being told what kind of retirement income they should be targeting would be a clear and material benefit for most members.

This wouldn't involve hugely complex calculations or extreme effort because an effective basis for this benchmarking already exists (see Chapter 4). However, providing members with this kind of contextual detail as a new 'rule of thumb' would be a significant step forward in closing the savings gap.

This is because people don't know what they don't know and can't easily react to something they're unaware of. Knowing that there is a retirement income target that is specific and relevant to your circumstances is powerful and far more effective in terms of creating a basis for better member engagement than vague exhortations to save for retirement 'because it's important'.

Outcomes, not inputs:



Our recommended focus on outcomes, not inputs, holds for consumer engagement as well as policy making.

We'd expect that no-one who has received an endowment shortfall 'traffic light' letter since April 2000 will feel particularly good about the experience, unless it was a pleasant shade of green. But despite being unwelcome news for many, the letters had an impact.

In 2000, the FSA estimated that around eleven million households would receive a letter because the endowment linked to their mortgage might not repay the mortgage amount. By 2005, figures showed that although more than two million households still faced an average shortfall of £7,200, more than half of those had taken action to tackle the problem in some way²⁹.

Members already receive annual statements estimating their benefits at retirement, based on various assumptions. It shouldn't be too difficult to articulate the same benefit values as a proportion of the member's target income and apply a Red, Amber or Green flag, reflecting the likelihood of achieving target income.

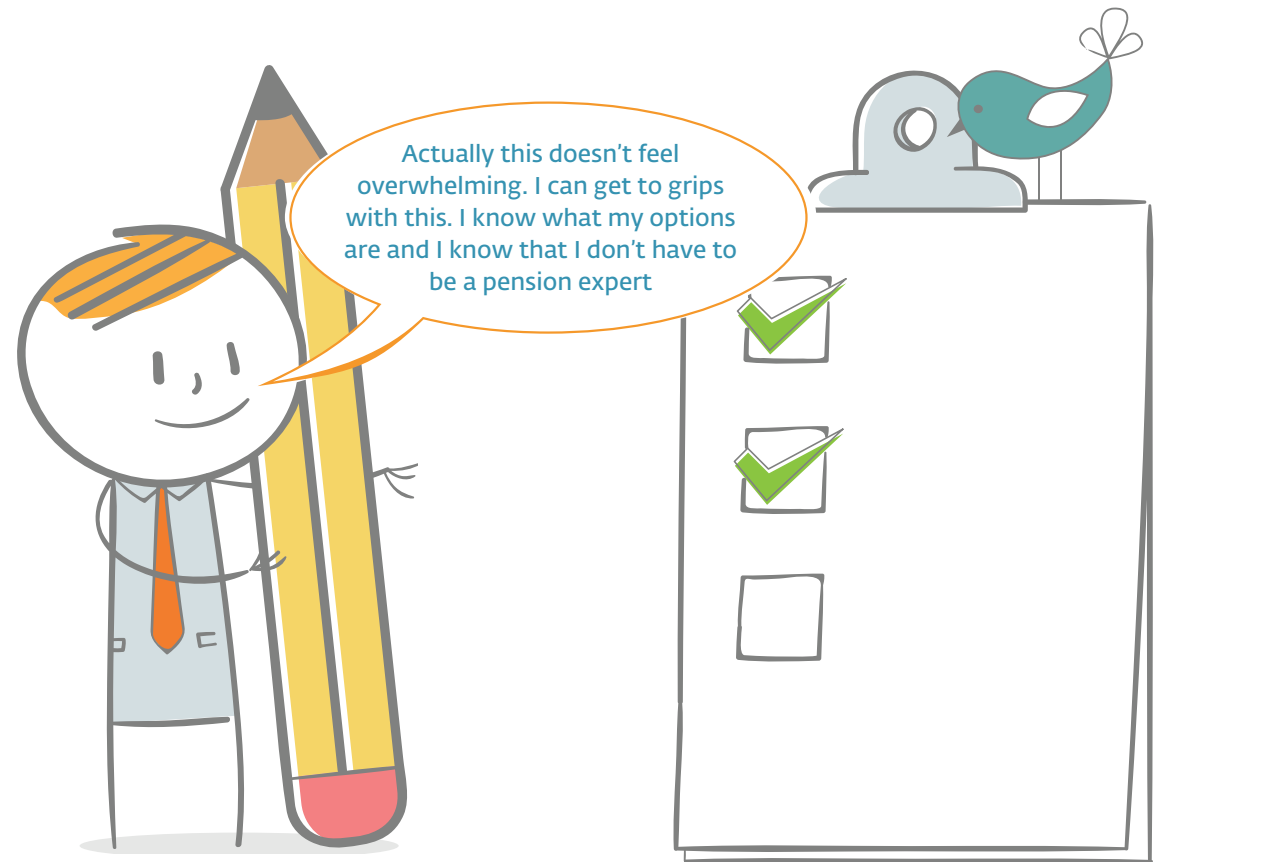
Ideally, such RAG ratings would include a member's retained benefits and estimated State benefits and so provide a holistic picture but this would involve overcoming the kind of difficulties that have made the production of combined benefit statements so problematic in the past.

The critical element of this approach is that it fundamentally involves the member in a dialogue about the nature of their retirement saving outcome.

Although the certainty/likelihood of a poor outcome may not be warmly received, it is a far stronger position upon which to base future decisions and actions than the currently most common member mind-set of 'I have a bad feeling about this but no detail so I'll just keep my fingers crossed'.



Engagement, not education:



Over two thirds of DC members that they would sign up to a scheme whereby a target retirement income was set and the scheme managed it for them.

Only 9% said they probably wouldn't join such a scheme.

Current UK Adult (DC) Pension Members Survey (19-25 March 2013, Opinium)

The next consideration is how to get people (like our member case studies in Section 5) to engage with ways they can take action if they are not on track to hit their retirement income target.

This is subtly but importantly different to the typical approach, which is to try and educate members about how their pension scheme works and the fundamentals of investing for retirement.

The latter assumes most members can be, or want to be, turned into investment experts. But the overwhelming incidence of 'double defaultism' (when members contribute at the default rate and are invested in the default strategy), suggests that such efforts are not working.

Part of the reason why trying to educate members about retirement saving has been largely ineffective is that much of the focus of the education effort has been on explaining detailed technical and operational information, rather than the 'big picture' of retirement saving.

In general, people perceive pensions to be pretty complicated, a bit scary and very dull; the way this makes them feel is confused, a bit anxious or simply disinterested and the result is that people often make no active decisions.

In order for people to make decisions they must first feel differently and the challenge here is to re-make the emotional connection that people have with the concept of saving for retirement.

There are two ways this can be facilitated. The first is by changing the main focus of pension scheme communication by emphasising the 'big picture', rather than the small print.

In 2008, a primary school in Redhill, Surrey invited a financial adviser to talk to the 8 year olds of Year 3 about saving for retirement...

The adviser asked the children if they knew what a pension was. Unsurprisingly, they didn't.

The adviser then asked a few questions about what the children's parents did for a living and what their older relatives did.

Having established that most parents had a job and that many older relatives had worked but didn't any more, the adviser asked another question: did they think it was a good idea to put some money aside when you had a job (like most of their parents) so that you'd have some money when you didn't (like many of their older relatives). Unsurprisingly, they all did.

Although Disclosure and Compliance requirements are clearly important and unavoidable, they should not be the key drivers of communication. The headline story of saving for retirement is simple and intuitive. People can engage with it as long as it is not buried amongst pages of technical detail.

Most organisations communicate in this order: firstly 'WHAT', then 'HOW' and finally 'WHY'³⁹. Traditional pension communication follows this model initially but often stops short of the 'WHY'. Leaders and organisations that want to communicate effectively, do so in the opposite way; they start with WHY, then HOW and finally WHAT.

Focusing on fundamental issues like those listed below, means changing the basic nature of the dialogue between scheme and member away from 'this is how the scheme works' and towards 'this is why you should save for retirement'.

- How life expectancy is increasing and what this actually means in terms of how long someone may be in retirement
- The changing nature and value of State provision and how this may limit financial options or restrict behaviour in retirement
- How much you're likely to need (links back to target income replacement rates) and where else that income might come from (see Chapter 4).

The second way of better engaging members is less about what is communicated than about how it is communicated.

Infographics is a visual communication technique used to convey both simple and complex content in an intuitive and memorable way.

Use of infographics has increased significantly in recent years:



Searches for infographics on Google increased by over **800%** between 2010 and 2012³¹



The hashtag #infographic was tweeted **56,765** times in March 2012 and at its peak 3,365 times in a span of 24 hours³²



This is because we are 'visually wired':



Almost **50%** of the human brain is involved in visual processing³³

70% of human sensory receptors are in the eyes³⁴

Humans can get the sense of a visual scene in less than **1/10th** of a second³⁵

It only takes humans **150ms** for a symbol to be processed and another 100ms for a meaning to be attached to it³⁶



Infographics help because we suffer from information overload:



We receive **5X** as much information today as we did in 1986³⁷

We consume **34 gb** of information – about 100,500 words on an average day – excluding time spent in work³⁸

On average, web users read only **28%** of words on a web page per visit³⁹



Infographics counter overload because they're:



More engaging

Colour visuals increase willingness to read by **80%**⁴⁰

+80%

More accessible

Pictures increase the comprehension rate of medicine labels from **70%** to **95%** PLUS people following directions with text and illustrations do **323%** better than people following just directions⁴¹

+95%

More persuasive

50% of audience members were persuaded by a purely verbal presentation but **67%** were persuaded when the verbal presentation had accompanying visuals⁴²

+67%

Easier to recall

People remember **80%** of what they see and do; **20%** of what they read and just **10%** of what they hear⁴³

+80%

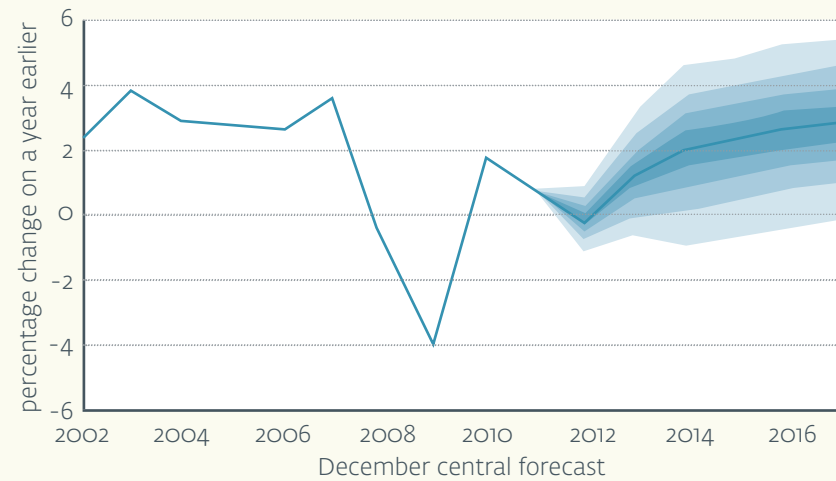




A good example of how infographics can effectively convey complex financial information is the Bank of England's use of 'fan charts' since 1997 to describe its best estimate of future inflation to the general public.

Fan charts extend a simple line chart for observed past data, by showing ranges for possible values of future data together with a line showing a central estimate or most likely value for the future outcomes.

Chart 1.1: GDP fan chart



Predictions become increasingly uncertain the further into the future they look and the range of possible outcomes widens, creating the fan shape.

Representing a range of retirement outcomes in this way for a given member could offer a more visual and intuitive option compared with traditional 'high medium and low return rate' illustrations.

Inspiration, not information:



By definition, communication is a two way process, the effectiveness of which is determined by the audience as much as (if not more than) by the communicator. As such, individual communication initiatives should reflect the nature and scope of the intended audience, as well as the communication environment in which they exist. One size does not fit all.

However, there are common principles and guidelines that will help increase the effectiveness of any communication effort; something that is increasingly recognised within the specific context of pensions:

National Association of Pension Funds: the PQM Guide to Good Communication⁴⁴

- Good communication starts with good planning
- Effective communication is clear, accurate and has impact.

The Pensions Regulator: Effective Member Communications⁴⁵

- Identify your objectives and have a clear communications plan
- Identify the best ways to communicate
- Tailor communications to the audience
- Remember needs of all groups, not just active members
- Be open and honest
- Avoid jargon
- Choose a good time to try to get members to engage.

CIPD: Pension communications: realising the value⁴⁶

- Define your desired outcome and make a communication plan
- Consider your audience/ message and communication channels
- See feedback and review effectiveness.

Organisation for Economic Cooperation and Development: Roadmap for the Good Design of DC Pension Plans⁴⁷

- ⦿ Communication must address financial illiteracy and lack of awareness.

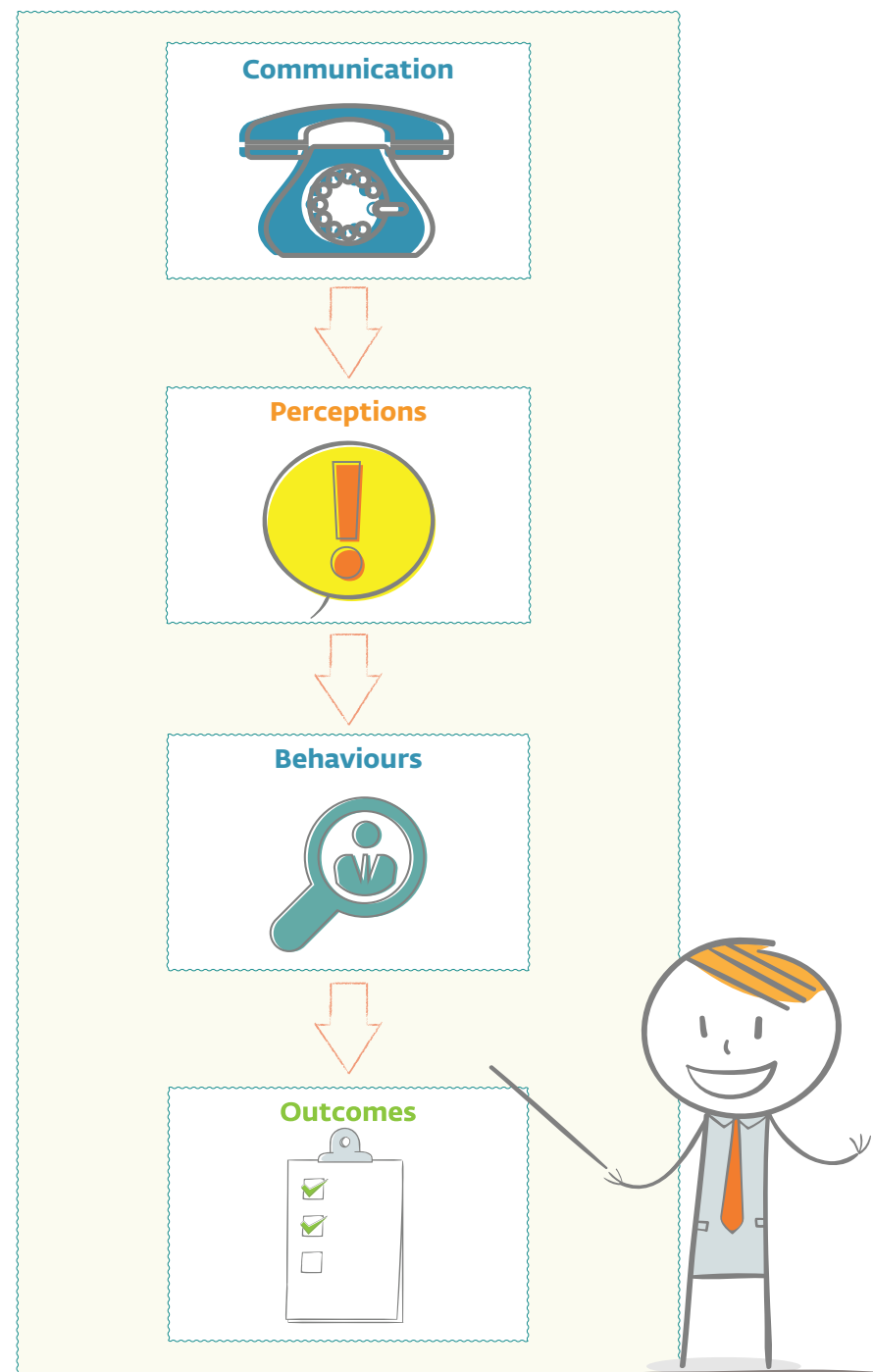
The common themes are around a strategic approach: a planned communication that considers the target audiences, their needs and preferences, in addition to content and technical requirements.

Recently, the European Insurance and Occupational Pensions Authority has gone one step further in Good Practices on Information Provision for DC Schemes: Enabling Occupational DC Scheme Members to Plan for Retirement⁴⁸:

- ⦿ Have a **behavioural objective** and support action
- ⦿ Provide headline information that answers key member questions
- ⦿ Maximise impact and reduce complexity.

It may seem like a relatively modest evolution but actively proposing that 'good' pension communication should have a behavioural objective, that it should help encourage action on the part of the member, is quite a radical departure from the traditional approach. Even those communication efforts which advocated enabling members to make informed decisions stopped short of seeking to actively inspire them to take action.

The challenge here is that moving people from 'being able to make an informed decision' to 'wanting to make a decision' requires a different kind of approach: one that is rooted in Behavioural Economics.



The IFoA published a discussion paper in 2011⁴⁹ that highlighted the importance of learning from Behavioural Economics when designing member communication. The paper listed a number of psychological biases which have been proven through various studies to influence individual behaviour.

One not listed but with significant potential implication for engaging members is the psychological bias of 'herding'. This is the natural tendency for human decisions and behaviours to be influenced by the decisions and behaviours of their perceived peer group or 'people like me' (i.e. the member).

Research has shown that creating a 'people like me' connection between a reader and a particular action can generate a 33% swing in favour of that action.

It's interesting to consider how opt out rates and/or contributions behaviours might be affected by communications that reference what the majority of 'people like me' do in the same circumstances.

How groups of 'people like me' are actually drawn for members can be as simple or straightforward as necessary. Delivering 'mass customised' communication to individuals based on segmentation that looks at demographics such as age, place of work and job type has been around for years but 'persona-fication' is a more recent evolution.

Persona-fication means not asking "What do I want to say?" but going beyond that and making a more direct emotional connection by asking instead "What does my audience want to hear?" and "What do they care about?" This enables communication to be delivered which much more effectively reflects the reality of the receiver, making it more relevant and hence more powerful.

Better engaging DC scheme members at the Royal Bank of Scotland

The challenge

On top of their pay, RBS employees receive pension funding (usually 15% of pay) and can choose how much of that they want to contribute to their pension. They also receive extra benefit funding. Anything not used is paid in cash.

This asks employees to take significant ownership of their retirement planning but in 2012/13, 27% of eligible employees weren't making pension contributions and 79% of those who were making any contributions did so at the lowest level – just 2% or 4% and certainly not 15%.

To put it bluntly, RBS employees were losing the battle against inertia and the desire to 'spend now, save later'. So the challenge was clear: to encourage active decisions and engagement from employees who had previously demonstrated little (if any) appetite for retirement planning.

The solution

RBS' strategy was equally straightforward: they turned pension communications on its head and made the communication about RBS people, not the RBS pension plan, because real people find it hard to relate to pensions. They often feel confused, anxious or apathetic, and these feelings prevent them from engaging with retirement planning.

So RBS decided to make people feel differently – and asked them simply to focus on life and 'Picture yourself tomorrow'.

From the 'Picture yourself tomorrow' tagline, to the tools selected, and the design that pulled it all together, RBS wanted employees to 'Make better choices for your future. Today'.

Talking to people, not employees

RBS developed a voice for our communications that delivered messages in jargon-free, everyday language. Importantly, this voice treated everyone as people (not employees), and their pensions as their money (not RBS').

For example, the guide quizzed people about whether they're a spender or saver in everyday life, then showed how this could affect their pension plans. Communications were not about life as an employee, but aspirations outside of work.

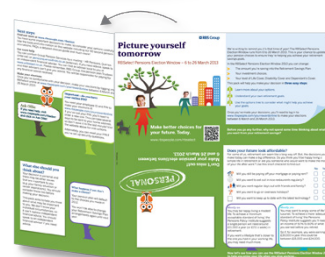
Tools to enable decision making, not just to inform

RBS wanted tools that would educate and guide employees through the decision making process, simply and easily. A personalised decision tree – a simple fold out tool on an A3 sheet – was delivered to everyone.

Employees were encouraged to unfold it, draw on it and physically engage with it. It asked them whether their future looked affordable and encouraged them to complete a quiz with questions like, 'Will you want to eat out in nice restaurants regularly?' It then took them to a targeted decision tree to help them make the right decision for them.

Designs to engage, not evaporate

A new brand stood out from other RBS communications and drove home the idea of 'Picturing yourself tomorrow'. Designs ensured key messages, calls to action and important information were always highlighted. Diagrams helped break down complex concepts like tax and NI savings. QR codes on posters and printed materials also linked employees quickly through to the website.



The result

The best RBSelect pension election window. Ever.

- DC contribution changes UP: 41%
- DC contribution increases UP: 49%

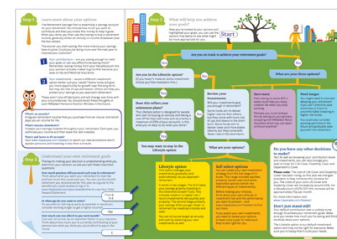
Member comments included:

In all the years I've worked here this is the most effective campaign regarding pensions that I've seen ... I feel better informed and confident in my choices for the first time...

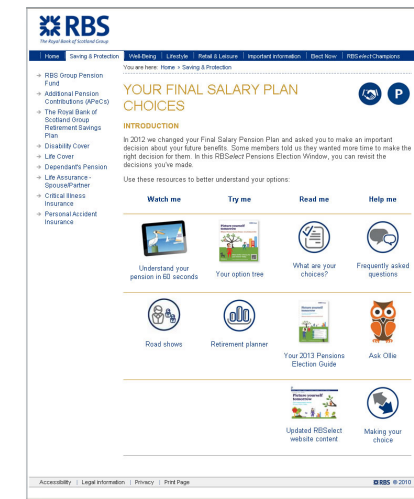
This is the first year I've understood how a pension works...

This year, the tools available to staff were second to none, the little video clips, 60 second snap guide and the online pension calculator tool were, quite frankly, brilliant! I spent nearly 10 years working for a competitor bank and I do not recall a single time where such quality tools and material were available for staff...

“ The work this year around promoting awareness and the importance of retirement planning was excellent. It shows that RBS cares and wants to ensure and help every employee to know and decide how they want to live their retirement... ”



Microsite



60 second animations



Defined benefit pensions in a minute

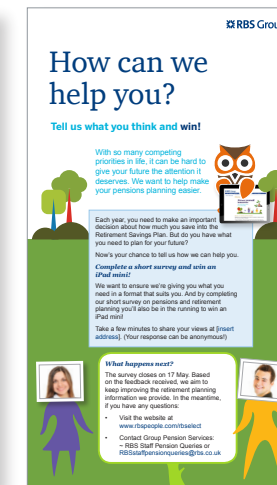


Investments in a minute

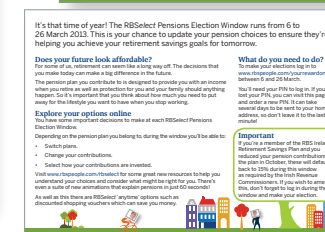


Defined contribution pensions in a minute

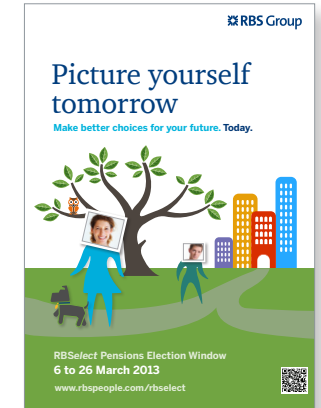
eCards targeted based on membership type and location



Postcards



Poster



Intranet banners accompanied by articles

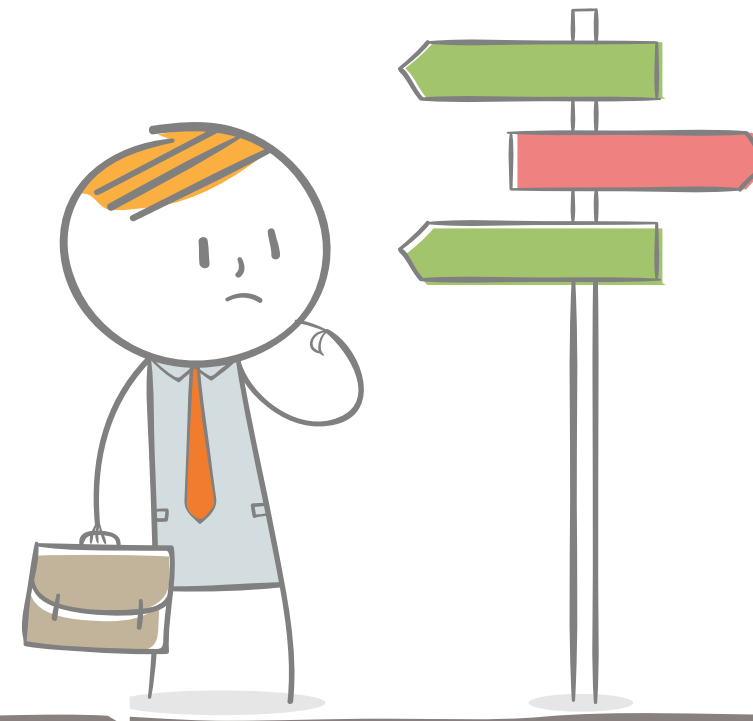
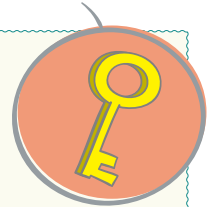


28: The Invisible Gorilla, Chabris and Simons, 2010
 29: <http://www.thisismoney.co.uk> 7 December 2005
 30: Sinek, S: www.startwithwhy.com
 31: www.google.com/insights/search/#q=infographics&cmpt=q
 32: "What is an Infographic", <http://www.customermagnetism.com>
 33: Merieb, E. N. & Hoehn, K. (2007). Human Anatomy & Physiology 7th Edition, Pearson International Edition.
 34: Merieb, E. N. & Hoehn, K. (2007). Human Anatomy & Physiology 7th Edition, Pearson International Edition.
 35: Semetko, H. & Scammell, M. (2012). The SAGE Handbook of Political Communication, SAGE Publications
 36: Thorpe, S., Fize, D. & Marlot, C. (1996). Speed of processing in the human visual system, Nature, Vol 381.
 37: Alleyne, R. (11 Feb 2011). Welcome to the information age – 174 newspapers a day. The Telegraph.
 38: Bohn, R. & Short, J. (2012). Measuring Consumer Information, International Journal of Communication, Vol 6.
 39: Nielsen, J. (2008). How Little Do Users Read?
 40: Dowse, R. & Ehlers, M. (2005). Medicine labels incorporating pictograms: Do they influence understanding and adherence?, Patient Education and Counseling, Vol 58, Issue 1.
 41: Levie, W. J. & Lentz, R. (1982). Effects of text illustrations: A review of research, Educational Communication and Technology.
 42: McCabe, D. & Castel, A. (2008). Seeing is believing: The effect of brain images on judgments of scientific reasoning, Cognition 107.
 43: Lester, P. M. (2006). Syntactic, Theory of Visual Communication.
 44: <http://pensionqualitymark.org.uk/publications.php>
 45: <http://thepensionsregulator.gov.uk/guidance/guidance-member-communications.aspx>
 46: <http://cipd.co.uk/NR/rdonlyres/26920B07-E574-4589-9AD5-E74B90866237/0/pensionscomms.pdf>
 47: <http://www.oecd.org/pensions/private-pensions/50582753.pdf>
 48: https://eiopa.europa.eu/fileadmin/tx_dm/files/publications/reports/report_good_practices_info_for_DC_schemes.pdf
 49: Consumer Information Working Party(2011): Transforming Consumer Information

7. Pension design challenges (including “soft” and “hard” guarantees)

Key points

- ⦿ The DA concept might include schemes where the employer and employee share the pension risk
- ⦿ Real income guarantees are likely to be too expensive, alternatives include:
 - a psychological , instrumental guarantee that encourages saving, or
 - a less certain promise, such as a narrowing funnel of doubt around final pension income.
- ⦿ In the short term, psychological guarantees could help keep members auto-enrolled, but we need to deliver better communication of benefits and engagement before we deliver more complex guarantees.



As DB plans have closed, many workers have lost the near-complete security they once had. DC plans shift all the investment and longevity risk to the employee. This change is particularly problematic for plan members when it is combined with a poor understanding of risk and the relationship between risk and return. Some commentators believe contribution levels would be higher if DC members were more confident their pensions were secure.

One element of a defined ambition (DA) concept might be a scheme that would sit somewhere between DB and DC in terms of member security, with the employer and member sharing the pension risk.

Steve Webb wants to encourage many alternative designs for DA and is in talks with insurers, fund managers and employee benefits consultants (EBCs) to discover how Government can change legislation to enable all suitable design ideas.

Collective DC

The original DA ideas seemed to resemble Dutch collective (CDC) schemes where risk is shared between generations of members as well as the employer. CDC schemes allow greater cost certainty to employers than DB schemes, but retain some pooling and risk sharing for employees unlike traditional DC schemes. As with DB schemes, members accrue nominal pension rights annually, but indexation of these benefits is dependent on fund performance. Pensions and increases can even be changed if fund performance is poor so CDC in itself does not provide any absolute guarantees. The risk sharing is provided by diversification and pooling of risk across generations of people. However, falls in fund value of different generations are likely to be highly correlated, so at the point people need help from others they may not be in a position to give it.

Many industry commentators do not see CDC as a sensible future approach, being somewhat akin to the scheme attempting to run its own with-profits fund without the member safeguards that the with-profits framework now brings. CDC is probably not the future of DA in the UK. It seems more likely that DA will either look like DC with additional "guarantees" or DB with fewer.

DB with fewer guarantees

A key strand of the Government's DA proposals is some form of reduced commitment for employers sponsoring Defined Benefit schemes, with employees taking a commensurately higher degree of uncertainty. The argument being that final salary schemes in particular have become unaffordable and that by reducing the employer burden we may hope that those still open can continue to provide benefits to members rather than follow the now well worn path to scheme closure.

Three particular models have been suggested by DWP:

- ⊙ Firstly a removal of two of the statutory ancillary features of DB – a spouses' pension and inflationary increases of pensions in payment. Either or both of these could be restored year by year at the employer's discretion, perhaps with regard to how well the scheme funding is performing
- ⊙ Secondly, an automatic transfer to a Defined Contribution scheme if the employee leaves service before reaching retirement age. The employee would be given the actuarial present value of his DB benefit accrued to date, but the employer would have no future liability for whether the now DC pension actually delivers what's expected or not
- ⊙ Thirdly, the employees could take a share of the longevity risk. This is achieved by setting a floating retirement age, linked to a longevity index calculated and published by Government Actuary's Department for this purpose. As national longevity increases the scheme's retirement age would be automatically increased in line with the index. Employees then have a choice between working longer for an un-reduced pension or retiring at their original date but on an actuarially reduced pension.

It is worth viewing these proposals through the outcomes lens that this paper champions. Against that basis they score quite differently.

Removing the ancillary features of spouse's pensions and indexation would still leave a DB scheme delivering the required target pension at retirement. But it might deviate progressively from the target outcome during retirement. Even a few years of high inflation could seriously erode the pensioner's purchasing power. And early death could leave a widow or widower seriously exposed to pensioner poverty.

Conversion to DC on leaving service sounds rather like the experience an airline pilot has when the auto-pilot system switches off. On entering DC space the saver would be heading in the right direction, but would need to seize the control levers and take ownership of the pension if the desired outcome is to be maintained.

The floating retirement age offers the greatest degree of outcome certainty. All the employee needs to do is to work on until the new retirement age is reached and the DB pension delivers the originally intended outcome. Of course this does assume that the employee is still fit to work and that the employer has work available that is suitable for an employee of advanced age.

The summary of consultation responses is not yet published by the DWP however there is no consensus from those responses that have been published individually. For example the NASUWT said they were "extremely concerned" by flexible DB, saying it could become "a model for retrospective changes to public service pensions" (source: http://www.nasuwt.org.uk/consum/groups/public/@salariespensionsconditions/documents/nas_download/nasuwt_011850.pdf).

Whereas the NAPF applauded the "a more principles-based and less prescriptive regulatory regime". (Source: http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~media/Policy/Documents/o362_DWP_consultation_reshaping_workplace_pensions_for_future_generations_an_NAPF_response_Dec_2013.pdf).

DC with real income guarantees

The most useful type of guarantee for members would be a real income guarantee, but this is likely to be prohibitively expensive for insurers to offer over the working lifetime of a scheme member. The most similar guarantees are found in retail financial services (but even a low volatility fund of 40% equity might cost around 150bpts per annum to provide both the longevity guarantee and a high watermark guarantee on the amount of income provided each year) and the costs vary greatly with the expected volatility of the unit fund chosen. There are a number of reasons why guarantee costs in the DC space may be less than in retail including lower distribution costs, passively invested funds, and much higher volumes. However, in order for the required scale a substantial proportion of the market would need to move to a consistent approach for guarantee provision with a small number of providers.

At the moment EBCs appear to be hoping for a guarantee charge of around 40 bpts or less per annum, which is unrealistic for a genuine real income guarantee.

This means manufacturers will need to offer either a shorter term guarantee or

1. a more economical, psychological guarantee, or;
2. a less certain promise (an ambition rather than a guarantee)

1

DC with psychological guarantees

Results from behavioural economics (source: Daniel Kahneman Thinking Fast and Slow) show that people tend to base decisions on relativities rather than absolutes, and can often make financial decisions based on the context of their recent past experience. Giving psychological guarantees follows on from these ideas. The worry is that negative press reports and recent falls in the value of their pension pot could lead them to opt out or switch funds into cash straight after a crash. In fact experience shows that DC members do not typically cease contributions when their funds fall in value, however there is a view that the auto-enrollers are less familiar with the ups and downs of the stock markets so may be more sensitive to this. Guarantees may help limit these behaviours and give auto-enrolled members the confidence to remain opted in.

Return of contributions guarantees

The simplest DA idea so far is a psychological guarantee being offered on DC default funds. This would be set at such a low level that it would not be exercised except in the worst scenarios. It would therefore not have a large cost but would have value instrumentally if it encouraged saving. Insurers may be willing to offer a nominal guarantee of contributions as a lump sum on retirement for example. Interestingly anecdotally feedback suggests that it may only be the employee contributions that need this guarantee. Members are keen to see that the contributions that they have paid in are not eroded, but appear to be less worried about how the employer's contributions are invested. Given that the different contributions within the pot are fungible, a guarantee of employee only contributions would be inexpensive for a typical auto-enrolment fund.

The industry is unlikely to supply this type of guarantee until regulators signal that they are happy with this approach. There are concerns in the industry that we would be vulnerable to the suggestion by a future Government that we had sold this as a valuable guarantee if in retrospect it was not perceived to have been worth very much.

There are other challenges around transferability of the guarantee when the member transfers fund or employer and how it should be charged for. There is little incentive to pay a basis point charge where instrumental guarantees are heavily out-of-the-money.

2

DA as a less certain "promise"

Higher probabilities of ruin

The UK insurance sector guarantee is well defined. Capital requirements are framed around a 1 in 200 risk of ruin and guarantees are priced using risk neutral scenarios to reproduce the market price of similar guarantees. Therefore, a promise with that level of risk is arguably viewed as a guarantee for reserving purposes. Defined Ambition could put lots of different levels of promise into the market all potentially being called a "guarantee". Whilst this is true for guarantees in other industries, such as white goods, the reputational risk to the pension idea is more serious as the expected lifetime of the product is longer. If all these promises are called defined ambition they will all be seen as being as good as each other.

One of the ideas set out in the government's Defined Ambition strategy paper, Reinventing Workplace Pensions, which it published in November 2012, was that a Government institution could take on a contributions guarantee for DC schemes. This guarantee would be cheaper than an insurance backed guarantee if such a body did not need to hold capital or need to price using risk neutral scenarios. It may have been possible for a supplier to provide richer guarantees more cost effectively by using this contribution guarantee as a kind of stop-loss reinsurance for its tail risk but the latest paper from the DWP appears to rule out this type of Government involvement.

It seems churlish to question a guarantee backed by the Government, but there does seem to be an issue here. The PPF is diversified, to some extent, because different industries struggle at different times in the economic cycle. DA guarantees are all likely to be based on the same investment markets. If one scheme had to call on the guarantee, they probably all would at the same time. The question then becomes: Would the Government printing money be a valuable guarantee?



DC with hedging but no actual risk transfer

A number of DC default fund investment strategies have already been developed that balance risk and return seeking, including lifestyling, multi-asset / absolute return strategies, CPPI, volatility targeting and Liability Driven investment (LDI). However, for the investor, these matching strategies have two serious disadvantages compared to a guaranteed floor from an insurance company (or financial institution):

- ⊙ Compared to a guarantee floor, the risk management is difficult to understand
- ⊙ The investor takes the hit if the hedges do not perform as expected (unlike guarantees, where the institution pays hedge losses if they would result in benefits less than the floor).

Operational risks of the investment strategy will be borne by the member unless there are additional employer guarantees. However by narrowing the distribution of expected returns these strategies ought to provide members with more certainty as to their pension benefits and therefore encourage contributions.

The ability to manufacture guarantees may give insurance companies an advantage that asset managers do not have, but insurers will actively participate in the market only if they can provide guarantees at a price acceptable to DC plans. Matching strategies may offer more cost-effective protection.

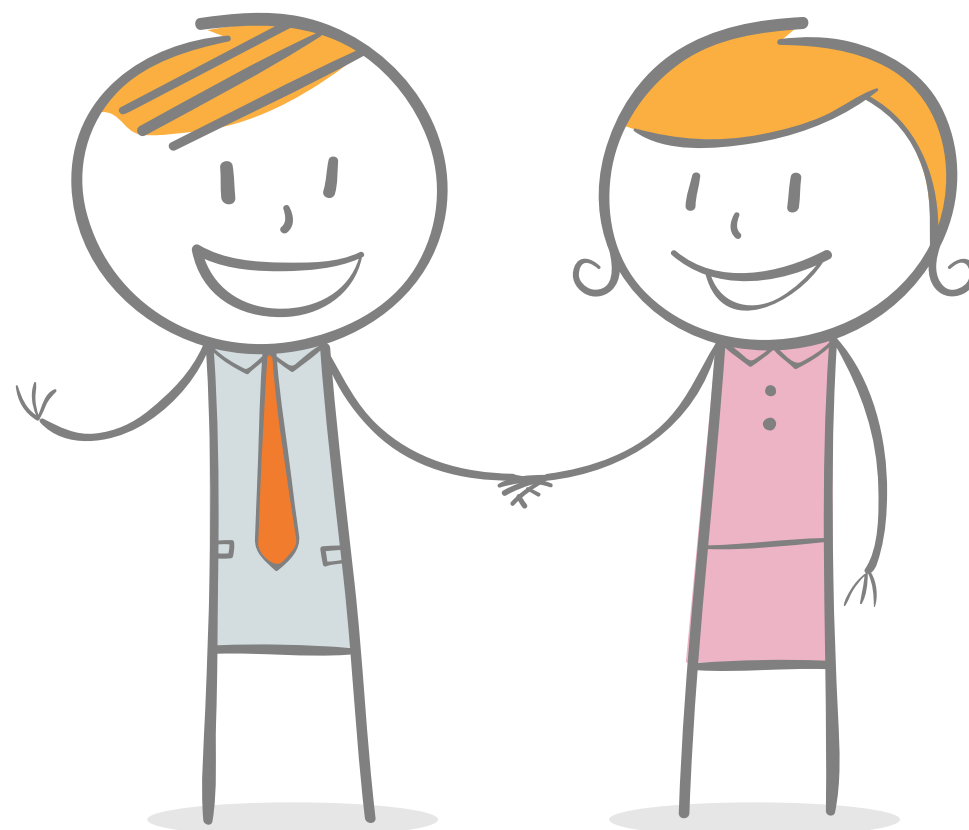
The Investment Products for Retirement Savings IFoA Working party wrote a report in 2012 entitled "Is there a place in the UK mass market for a guaranteed pensions product" which compared the cost and outcomes of different hedging strategies and guarantees.

Homing in on final retirement income

Some of the suggested designs that attempt to offer a less certain but useful promise have complicated structures. For instance, a plan might ladder purchase variable or deferred annuities over time, with contracts payable at a series of older ages. This strategy mitigates interest rate risk by avoiding a one-time purchase, and allows some investment control. The member sees a narrowing funnel of doubt around the expected pension benefit reported each year. It is not a guarantee but an ambition with upside potential that slowly crystallizes into a guarantee. This complex structure makes the promise cheaper and more robust for society than a full guarantee, but questions remain about whether we can explain it.

Conclusions for pension design challenges

Whilst the proliferation of designs is intended to stimulate innovation it may not be the best approach if it leads to a fragmented market where the public do not understand the difference between guarantees, are "paralysed by choice" and where no firm can achieve the economies of scale needed to write guarantees cheaply. There is no doubt that some members need guarantees but it will be easier for employees and employers to see the value in guarantees if they can see how they fit with what they are trying to achieve. Or to put it another way – it is key to deliver better communications and engagement before we deliver guarantees.



Appendix – assumptions for case studies

Assumptions	
Annuity interest rate	3%
Annuity term (years)	25
State pension (in today's terms) pa	£7,488
Inflation pa	2.5%
Individual's Salary inflation pa	3.0%
Investment return (less charges) pa	4.5%

Also assumes:

- ⊙ A level annuity
- ⊙ Band earnings definition for pensionable pay for Joe (and so 5% minimum employee contribution and 3% minimum employer contribution – assumed from outset and not assuming lower contributions initially before they step up to these levels in 2018)
- ⊙ Basic pay definition for Mary (and so 5% minimum employee contribution and 4% minimum employer – again assumed from outset).