Deep Contemplations # 1

What does good look like in Defined Contribution?

February 2017

Summary

- The views of savers and employers are most relevant in assessing ‘what good looks like’ in Defined Contribution (“DC”) pensions.
- We’ve reviewed third-party studies in order to form an independent view of what savers and employers want from DC.
- The Government is encouraging private-sector retirement provision, as shown by the introduction of auto-enrolment. So, we’ve sought to capture the Government’s views to provide as comprehensive a perspective as possible.
- We’ve distilled these views into four straightforward questions that can be used by employers, savers and advisers to evaluate existing DC provision or help set up a new provision:

    1. What will I get out?
    2. How much needs to be put in?
    3. How much will be charged in fees?
    4. Am I on track?

- Successfully establishing whether an arrangement is fit for purpose increases the likelihood of achieving good outcomes in the future.

Introduction

Retirement. Most people have an idea of what they want theirs to look like. But few know what their Defined Contribution ("DC") pension contributions will amount to, in terms of retirement benefits, when retirement arrives.

It's a concern for businesses too. Every company in the UK will be required by law to provide a pension for their staff by 2018. But how do they choose the right one?Savers face similar questions. Unless they opt out, they're automatically included in the company's pension arrangements. Should they stay in or make alternative arrangements?

Despite these pressing questions, everyday financial pressures often push retirement planning to the back of many people's minds.

We want to help savers and employers achieve better outcomes.

The purpose of this paper

The two main players in any workplace DC arrangement are the saver and the employer. But with the introduction of auto-enrolment, the Government has also staked an interest.

We have reviewed third-party studies from well-known providers, intermediaries and think tanks to find impartial answers to what savers, their

employers and the Government want from DC arrangements.

By exploring these three key perspectives, we've been able to create a concise framework to help savers and employers evaluate their existing or prospective DC arrangements. Establishing whether an arrangement is fit for purpose increases the likelihood of achieving good outcomes for everyone involved.

The saver

The saver is at the centre of DC provision. After all, it's their quality of life that is directly impacted by their DC savings once they finish full-time employment.

While DC savings might not be the saver's only financial resource during retirement, it will likely be their biggest asset other than their home.

This is why getting it right is so important.

"What will I get in the end?"
According to research by NEST[1], this is the question that consumers want answered the most. This is because in DC arrangements, contributions are known in advance while the outcomes are not.

NEST's research found that retirement planning is all about "safety and securing the future", and is therefore "at odds with the idea of taking risks".

"This paradigm," they said, "produces a desire for certainty."

They found this desire for certainty also brought certain expectations: "Pension pots are expected to grow like a savings account, but with contributions stacking up and attracting more growth than standard savings interest rates. Rather than frequent ups and downs, consumers expect to see smooth and continuous upward growth."

In fact, this desire for steady growth is so strong that their research found many people would prefer an option offering predictable returns "even if it didn't keep up with inflation over the long term".

Unknown outcomes
Real-world evidence is that savers have little idea of how much their savings are going to amount to come retirement.

[1] NEST – 'Improving consumer confidence in saving for retirement' (July 2014)

The Joseph Rowntree Foundation[2] asked those on a low income what they expected the ratio of their post-retirement income to their pre-retirement income to be. By far the most popular answer given was that they had not thought about it.

This lack of planning affects people's ability to determine when to stop working. The Foundation found that "two-thirds of those who expected to retire within a year were still working one year later, suggesting that even those close to retirement substantially overestimate their likelihood of retiring."

A shock for savers

In their own research, Aviva[3] found many savers described "shock at discovering their pensions and other arrangements were unlikely to fund the kind of retirement they had envisioned". In fact, almost two-thirds of retirees asked by HSBC[4] said they only realised they hadn't saved enough after stopping work.

Aviva's research[5] also suggested that more than one in three employees over the age of 50 expect to retire at a later date than they hoped when they were 40. On average, this meant working eight years more than planned, with lack of savings and lingering debts cited as the key motives.

Income or lump sum

Savers have consistently expressed a desire to take their retirement benefits in the form of a lifetime income. Nearly 70% surveyed by Aon Hewitt[6] expressed a desire for a "steady, secure income", where they would not outlive their retirement savings.

[2] Joseph Rowntree Foundation – 'Preparing for later life; working longer and saving more' (January 2016)

[3] Aviva – 'Retirement Uncovered' (2016)

[4] HSBC – 'The Future of Retirement' (2015)

[5] Aviva – 'Working Lives report' (2016)

[6] Aon Hewitt – 'In a brave new pensions world what will DC members really want?' (December 2014)

State Street Global Advisors[7] found that 81% of schemes themselves felt that retirees "still need the security of some regular predictable income, similar to that provided by an annuity".

A panel of trades union representatives and consumer groups told the Independent Review of Retirement Income[8] that "the primary aim of a good DC scheme should be to provide a lifelong index-linked income in retirement".

How much contribution is enough?

One of the main factors determining how much you get out of your DC pension ultimately hinges on how much you pay in. However, a study by BlackRock[9] confirmed that many "don't know how much to put aside for retirement".

This suggests that most savers have little idea how much is needed to reach the level of retirement benefit they would like. Or how much their current rate of saving is likely to deliver at retirement.

Shortfall ahead

Many savers do acknowledge their savings' shortfall though. Two-thirds of the group surveyed by the Savings and Investment Policy Project[10] recognised they are not saving enough, in part due to a "seismic shift in cultural attitudes where living for today has taken priority over providing for tomorrow".

[7] State Street Global Advisers – 'Retirement Income: Exploring the Future of DC' (March 2016)

[8] 'Independent Review of Retirement Income: Report' (March 2016)

[9] BlackRock – Global Investor Pulse survey, conducted in association with research agency Cicero Group from July to September 2015 amongst a nationally representative sample of 30,500 individuals in 20 countries aged 25 to 74 years old, of which 4,000 were UK residents (2015)

[10] http://www.tisa.uk.com/releases.html?release_id=589

The employer

The employer's perspective counts for a lot in DC, as the majority of DC arrangements will be set up in the workplace.

Beyond the mandatory auto-enrolment requirements, DC schemes can play a significant role in workforce management, whether intentionally or not.

How does the company benefit?
DC arrangements present different uses for different employers. For some, it's simply a case of complying with auto-enrolment rules. For others, as found in research by Aviva[5], it can be used competitively to attract and retain staff.

However, conflicting research questions the effectiveness of DC arrangements as a way of retaining staff. The Independent Review of Retirement Income[8] points out that the pension freedoms of the 2014 Budget, combined with legislation removing the right to retire employees at a specific age, have meant the pension scheme "has fallen apart" as the key tool for managing employee retirement.

With no Default Retirement Age in the UK[11] retirement-age employees who have not made sufficient provision are likely to be "trapped" in work. This presents challenges in workforce planning and management. What's more, the productivity of these employees is likely to suffer as their financial concerns impair their focus, presenting further challenges to the employer.

Competitive contributions
Many employers appear to be emphasising the level of contributions, possibly as part of a short-term employee attraction and retention strategy. The problem with this competitive approach, as found in research by Willis Towers Watson[12], is that employers focus on what goes into DC, rather

[11] https://www.gov.uk/working-retirement-pension-age

[12] Willis Towers Watson – 'Adequate retirement income not a priority for UK employers' (March 2014)

than what comes out at the end. In fact, only 15% of UK employers surveyed said their objective for providing a DC pension plan is to ensure their workers save for an adequate retirement income.

Do the fees charged represent good value?
The choice of DC arrangement is an employer decision. The contributions generally come from the employer too – either directly or indirectly (via deductions from the employee's salary). Consequently, the Independent Review of Retirement Income[8] found that the employer is bound to have an interest in the costs of provision and getting value for money.

The Government

The UK Government and related regulatory bodies have generally been consistent on their view of what DC pensions should deliver. However, this message doesn't seem to have been clearly communicated.

What should a DC pension scheme deliver?
The Pensions Regulator[13] has been unambiguous in its aspiration for DC pension schemes, describing "the ultimate outcome of a good scheme" as achieving an adequate income for its members in retirement.

This view was followed up by the then Pensions Minister[14], Steve Webb, who said that future pension provision "has to provide more certainty for people about what their pension income might be".

His department, the Department for Work and Pensions (DWP)[15], said it favoured models that "seek to secure a guarantee on the income that will be received in retirement that builds up gradually during the savings period".

"This approach," it continued, "has the benefit of allowing the member to see ongoing growth, combining certainty with a focus on the primary objective of pension savings – retirement income. It also assists employers' needs in respect of workforce management".

[13] The Pensions Regulator – 'Enabling good member outcomes in work-based pension provision' (January 2011)

[14] Department for Work & Pensions Press Release – 'Pensions Minister Steve Webb today laid down a summer challenge to industry that pension provision has to provide more certainty' (3 July 2012)

[15] Department for Work & Pensions – 'Public consultation: Reshaping workplace pensions for future generations' (November 13)

Making sure buyers know what they're getting
The DWP also described how the default investment strategy in an auto-enrolment scheme should be communicated[16]:

- It should have a high-level objective, which explains in broad terms what the default option aims to do and the strategy it will use to achieve this aim – this should be reflected by its name
- The overall objective should cover a simple description of how the investment strategy will manage risk, including what it aims to achieve for member outcomes

The corresponding view of the Financial Conduct Authority[17], with respect to all contract-based pension products including the default, is that firms need to provide customers with enough detail about a fund in a clear and concise manner that they can understand. Not providing enough information or using jargon can limit their ability to make informed investment decisions.

Freedom and choice
The Government's introduction of "freedom and choice" in 2015 has muddied the waters somewhat, while retirement needs have remained the same.

According to Aviva's research[5] above, the vast majority of employees do not intend to alter plans because of the pension reforms. In fact, 71% stated that they have no plans to retire or change their planned retirement age. Only 8% highlighted that the freedoms will result in them retiring earlier, contrasting somewhat with the concerns employers have around the loss of skilled employees.

[16] Department for Work & Pensions – 'Guidance for offering a default option for defined contribution automatic enrolment pension schemes' (May 2011)

[17] Financial Conduct Authority – 'Meeting investors' expectations' [TR16/3] (April 2016)

The Pensions Regulator, responsible for regulating work-place pension schemes, noted[18] that the lack of consumer engagement with pensions drives the default approach of automatic enrolment. But they also recognised that the introduction of pension flexibilities heightens the risks to good outcomes for their members.

[18] The Pensions Regulator – 'Freedom and choice. How occupational pension schemes have implemented the pension flexibilities' (March 2016)

Working out what good looks like in DC pensions

Asking the right questions today can help everyone providing or paying into a DC pension scheme to achieve a better outcome in future.

Distilling the views of savers, employers and Government explored earlier, we've developed four straightforward questions to assess DC provision and products.

1. What will I get out?
Savers and employers will have questions when it comes to their DC arrangements. What matters to them both is understanding the outcome.

For savers, this will mean knowing how much they're going to get out, in what form and when. For employers, this will mean knowing if their staff are going to be able to retire when they want them to.

The following questions will help both savers and employers to understand the features of a particular pension and whether it's right for them:

- **What is the objective of pension provision?** (e.g. I want to/my staff to be able to retire at 65 with benefits of a specified level.)
- **What type of benefit is provided?** (e.g. Income, lump sum, drawdown.)
- **What age will the benefit be paid from?** (e.g. I want to/my staff to receive the benefit from 65.)

The financial risks in the product arise from these features. Post-purchase, these same features allow the buyer to check whether the product is likely to deliver what they wanted at purchase (see Q4).

2. How much needs to be put in?
Is there an explicit link between what participants want out of their DC provision and what goes in?

YES – are contributions set at a level likely to deliver what participants want out?

NO – should action be taken to align contributions and likely outcomes and, if so, what?

3. How much will be charged in fees?
The fees charged for providing the pension will impact the likelihood of participants getting out what they want. Fees cover administration, investment management, communication and all other aspects of providing the pension arrangement.

4. Am I on track?
DC saving is a long-term commitment, where the final outcome might take years to emerge. This means it's important to track progress over time and work out whether any corrective action is needed along the way.

Both savers and employers will need to regularly check their arrangements. For savers, this will mean knowing whether they're on track to receive what they want, when they want it. For employers, this will mean knowing whether their staff are on track to retire when they want them to.

Taking the features identified in Q1, both savers and employers should be able to establish metrics for tracking progress by asking the following questions:

- **What is the benchmark?**
  (i.e. What is the combination of financial instruments that most closely reflects the objective? Investment performance can then be measured against this reference metric.)

- **What is the outperformance target relative to the benchmark?**
  (i.e. What is the pension arrangement aiming to deliver relative to the reference metric?)

- **How is risk defined?**
  (i.e. What measure of risk is used: permanent loss of retirement benefit, annual volatility, etc.?)

- **What is the risk budget?**
  (i.e. Given the risk measure defined above, what is the maximum amount of risk that might be taken?)

The above questions can be used by employees, savers and advisers to evaluate their existing DC provision. Where there is no current provision, the questions can help in choosing an arrangement that will help savers and employers achieve the outcome that matters to them.

Next edition…
In our next edition of Deep Contemplations, we'll assess the main Qualifying Workplace Pension Schemes in the UK by seeing how the features of these Schemes map against these same four questions.

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