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INTELLIGENT THINKING

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What will it take to get the nation saving?

Chris Wagstaff, Head of Institutional Marketing, considers the impediments to pensions saving in the UK and what it might take to get the nation to finance life after work more sustainably.

Key messages

- The UK has been accused of being the worst in the world for saving for retirement
- The UK DC pensions market is predicted to grow more than six-fold to 2030 to £1.7tn AuM
- At end-2012 just over a quarter of the workforce in the UK actively contributed to an occupational pension scheme
- Savings initiatives prospectively include introducing a universal rate of tax relief on contributions, a Lifetime ISA and collective DC, though mandatory saving might be the only way forward to avoid pensioner poverty
- A focus on quality and value should follow from the introduction of the 0.75 per cent charges cap on default funds and the central role of active management in delivering desired outcomes

Key statistics

- UK DC AuM in 2030 should be equivalent to about 80 per cent of UK GDP
- In 1967, 12.2m employees actively contributed to an occupational pension scheme versus 7.8m at end-2012
- 4.4m individuals have been auto-enrolled since October 2012
- Average employer and employee contributions to occupational DC schemes at end-2012 were respectively 6.6 and 3.1 per cent of salary
- Someone on UK average earnings should be contributing six times what they are currently contributing to their DC scheme to generate an annual income in retirement of £16,200

Reading one of the headlines from *VfM: Assessing value for money in defined contribution default funds*[1], one in a long line of well-researched and highly-insightful Pensions Institute reports, got me thinking. The report suggests that following the introduction of auto-enrolment in October 2012, the value of the Defined Contribution (DC) pensions market is predicted to grow more than six-fold by 2030, from £276bn assets under management (AUM) pre-auto-enrolment to about £1.7tn.

£1.7tn sounds like a big number. Indeed it is – being around 120 per cent of UK GDP *today* and probably 80 per cent of GDP in 2030. But will that sum, if spread widely across the working population, be sufficient

> "There's been a lot of talk... maybe too much talk."
>
> U2 – Sunday, Bloody Sunday (1983)

to provide a comfortable retirement for all of those not fortunate enough to have been a member of an occupational Defined Benefit (DB) scheme for most of their working life? I'm not only talking here about Generation Y (those born between 1982 and 1999), but also many of those in their late-40s and early 50s – the tail end baby boomers – almost all of Generation X (those born 1966 to 1981) and, in time, the New Millennials. After all, collectively these cohorts (excepting the New Millennials at present) account for the bulk of the UK's 30m+ workforce[2].

Obviously, the idea of focusing the minds of 1.2m employers and 11m lower to middle income employees on saving for the latter's retirement is a welcome development given the distinct lack of saving amongst this particular cohort, not to mention the need to make good the marked decline in private sector occupational scheme provision since the start of the new millennium. Indeed, recent ONS data suggests that at end-2012 only 7.8m people in the UK actively contributed to an occupational pension scheme – that's just over a quarter of the end-2012 workforce – of which a mere 1.7m were in a private sector DB scheme and 1m in a DC occupational scheme[3].

These numbers are in stark contrast to the 12.2m employees who were members of an occupational pension scheme in 1967 – the peak of occupational pension scheme membership, albeit when scheme membership was mandatory. However, to the 7.8m scheme members at end-2012 can be added the 1.4m self-employed individuals who actively contribute to a personal pension plan[4] and the 4.4m employees who have been auto-enrolled to an occupational pension scheme since October 2012[5]. That said, even taking these numbers into account, the 13.6m of those actively contributing to a pension scheme still amount to less than half of the working population.

As to contribution levels, average contributions to occupational DC pension schemes – both employer and employee – remain at meagre levels, at 6.6 per cent and 3.1 per cent of salary respectively[6]. Compare this to Australia where their compulsory superannuation system requires employees to make a mandatory contribution from salary of 9.5 per cent, with many employers matching this and the government topping these contributions up with an annual payment of up to £300 for those on a low income[7].

Moreover, the derisory two per cent of salary contributions currently being paid through auto enrolment (rising to eight per cent in 2018) are far removed from both the OECD's recommendation of the 15-18 per cent of salary required to generate the sort of replacement ratio that will provide a comfortable retirement and the 12 per cent recommended by, think tank, the *Policy Exchange* in their, somewhat depressing, report released in January[8], but it's a start.

Indeed, the House of Lords Select Committee on Public Service and Demographic Change, noted in its report *Ready for Ageing?* in March 2013 that "the UK is the worst in the world for saving for retirement."[9] Just witness the average pensions' pot of £36,800 identified by the *Policy Exchange* report – enough to purchase an annuity of just £1,340 at end-2013 – an amount totally removed from the £16,200 suggested by the government to fund a semi-decent retirement in 2014. In fact, the report suggested that someone earning the average UK annual salary of £27,000 should be saving *six* times the amount currently saved to generate this level of income.

The big problem, of course, is that we're not a nation of savers. Delayed gratification is not our thing. One only has to look at the narrow base upon which the economic recovery is based – principally consumer spending – and the barely positive savings rate that follows from this, to see that. Furthermore, there seems to be widespread ignorance of the fact that in a world of low growth, productivity and real interest rates, investment returns from hereon will, on average, be lower than investors have come to expect.

So what will it take to get the nation saving meaningful amounts into their pension pots? Or to phrase it slightly differently, how can people be weaned off their somewhat unsustainable lifestyles to take responsibility to finance a more sustainable financial future for themselves? Can hearts and minds be won simply through education as is so often suggested? How about plying basic rate taxpayers with greater tax incentives? After all, Pensions Minister Steve Webb has hinted at applying a universal rate of tax relief on contributions somewhere between 25 and 30 per cent. Michael Johnson at the Centre for Policy Studies, in targeting the under-35s, has even suggested that the Treasury give savers 50p for every pound they invest into a *Lifetime ISA* with an annual contribution limit of £8,000[10]. This proposal has so far met with a mixed response from the industry.

> "How can people be weaned off their somewhat unsustainable lifestyles to take responsibility to finance a more sustainable financial future for themselves?"

Or perhaps it's the current largely-unfit-for-purpose DC model that turns people off? After all, this model places the volatility, drawdown and inflation risks – the real capital preservation risks - associated with the DC accumulation phase with those least able to manage them. Steve Webb's proposed defined ambition collective DC approach is probably a move in the right direction. Think with profits-style intergenerational risk sharing *but* with the added benefit of the scheme's sponsoring employer assuming some of the real capital preservation risks. However, this approach has its detractors and remains a work-in-progress.

Significant criticism can also be directed at occupational DC default fund design, with the vast majority of default funds still being fixated with potentially volatile equity-rich asset allocations. Multi-asset, absolute return default funds with a CPI-plus medium- to long-term return objective, targeting bond-like volatility, are a much more appropriate default medium, being more robust against a multitude of economic and investment scenarios. Moreover, the 0.75 per cent charges cap applying to all default funds of DC schemes used for auto-enrolment from April 2015 has brought a renewed focus on expenses management in the default fund space. However, this focus should not be a race to the bottom. Rather, it should home in on quality and value, with active management playing a central role in delivering desired outcomes to the overwhelming majority of those DC scheme members who select or are opted into the default fund option.

However, it is perhaps the soon-to-be-implemented DC pension freedoms from next April that above all else will encourage the populace to start saving more sustainably for a comfortable retirement, secure in the knowledge that they will not be subject to the caps and limits previously applied to the decumulation phase.

These pension reforms probably also render the mechanistic and rudimentary lifestyling adopted by many DC work-based schemes, to which most scheme members are automatically opted in, a little outdated. Although target date return funds are slowly gaining traction, these are by no means a panacea. Rather these newly empowered investors seeking positive outcomes in the post-annuities world require intelligently constructed, well diversified and actively managed absolute return funds, diversified growth funds with specific CPI plus return targets and high yielding multi-asset income funds, that respectively offer the genuine prospect of real capital preservation, real investment returns and a real long-term income stream.

Add to all of these developments in the DC space the imminent application of new governance standards for all DC workplace pension schemes and you have a much more appealing DC proposition to the average DC scheme member.

That said, the overriding worry remains that all of these great strides forward could still be trumped by a continued lack of trust in the savings industry, courtesy of a succession of high profile scandals, debacles and transgressions – such as overly zealous legacy charging structures – over the past couple of decades. Despite a significant clean up and much stricter regulation of the industry in recent years, if this lack of trust has become so deeply ingrained in the public's psyche that it has simply become insurmountable, then more draconian measures may need to be applied to raise the level of pensions saving. If so, then perhaps a paternalistic move – away from the libertarian paternalistic nudging that is auto enrolment – to mandatory saving is the only way forward. Indeed, this was the conclusion reached in the *Policy Exchange* Report, mentioned earlier, given the jaw-droppingly concerning statistic that 11 million people are at risk of entering "pensioner poverty" when they retire.

However, if compulsion is seen as the way forward, then adding a further degree of financial freedom – perhaps allowing pre-age 55 access to a percentage of the individual's pension pot for house purchase for instance – might be a more palatable and socially acceptable approach to getting the nation saving.

[1] VfM: Assessing value for money in defined contribution default funds. Pensions Institute, January 2014.

[2] ONS Labour Market Statistics 2014.

[3] ONS, OPSS 2013. The end-2012 workforce numbered 29.65m, of which 4.2m were self employed and not eligible to join an occupational pension scheme.

[4] ONS, OPSS 2013.

[5] The Pensions Regulator, September 2014.

[6] ONS, OPSS 2013.

[7] Australian Taxation Office

[8] Help to Save: Diffusing the Pensions Timebomb. Policy Exchange, 22 January 2014.

[9] Ready for Ageing? House of Lords Select Committee on Public Service and Demographic Change, 14 March 2013.

[10] Radical pension plan pitched to UK government. FT.com, 3 August 2013.

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