Your success. Our priority.

PENSIONS WATCH – ISSUE 6:
WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

**Chris Wagstaff, Head of Pensions and Investment Education,
Columbia Threadneedle Investments and Senior Visiting Fellow, Finance Faculty,
the Business School (formerly Cass), London**

In this edition we focus on why, how and to what extent to increase contributions to defined contribution schemes if good retirement outcomes in the UK are to become the norm.

What is a good retirement outcome?

The central theme running through Pensions Watch to date has been the need to make good retirement outcomes in the UK the norm. Defining what constitutes a good retirement outcome has been made easier by the PLSA's Retirement Living Standards.[1] The PLSA suggests, as a rule-of-thumb, that for a single person in retirement, a gross income of £10,200, £20,200 and £33,000 will respectively provide a minimum, moderate and comfortable standard of living. For a couple, the corresponding numbers are £15,700, £29,100 and £47,500.[2] To put this into context, for someone with a full 35 year NICs record, the State Pension in 2020/21 pays £8,767 at State Pension age (SPa) – equivalent to 28.4% of pre-retirement income for the average UK earner.[3]

As people increasingly become solely reliant on their defined contribution (DC) pension pots to support their standard of living in retirement, achieving each of these outcomes is partly contingent on the amount a DC saver contributes over their lifetime to their DC plan(s).[4] Currently, the median employee and employer contribution to an occupational DC trust-based scheme is 4% and 3% of band earnings respectively,[5] while the minimum total contribution to an auto enrolled scheme is 8%. And therein lies the problem. According to the Pensions Policy Institute (PPI), "a median earner might need to contribute between 11% and 14% of band earnings to have a two-thirds chance of replicating working life living standards if contributing between age 22 and SPa."[6] Additionally, the Resolution Foundation, in seeking to establish what constitutes a socially-acceptable adequate standard of living in retirement for low to middle income earners,[7] suggests that, "low-to-middle income employees aged 25 today would need to save an *additional* £600 a year …equivalent to 3% of gross earnings, and a 35-year-old would need to save an *additional* £1,300, equivalent to 7% of gross earnings."[8]

Although recently reduced consumer spending is showing up in a dramatically higher (short-term) household savings ratio,[9] the current economic environment is, quite understandably, diverting attention away from long-term saving. However, delaying, cutting back or taking a break from contributing to a pension scheme, even for just a few years, can have a marked impact on the percentage of earnings that will need to subsequently be saved if one's standard of living isn't to suffer in retirement. Such is the power of compound interest.

[1] See: https://www.retirementlivingstandards.org.uk/
[2] This can be summarised as 10k-20k-30k for singles and 15k-30k-45k for couples.
[3] OECD (2019), *Pensions at a Glance 2019: OECD and G20 Indicators*, OECD Publishing, Paris. p.155.
[4] Good retirement outcomes are also dependent on how those contributions are invested and the choices made at and in retirement.
[5] The DC Future Book 2020. The PPI in association with Columbia Threadneedle Investments. September 2020. pp.20-23.
[6] The DC Future Book 2020. Op.cit.
[7] https://www.resolutionfoundation.org/publications/building-a-living-pension/. January 2021.The report sets out a framework through which a 'Living Pension' for low to middle income earners could be calculated.
[8] The Resolution Foundation. op.cit. pp8-9
[9] See: https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/dgd8/ukea

So how do we achieve materially higher DC contribution rates?

Although the long mooted widening of auto-enrolment eligibility would achieve more widespread pensions saving, to achieve *materially and enduringly* higher DC contribution *rates*, policymakers essentially have two choices (three if you include member education).[10] They can (1) compel the nation to save, *or* (2) implement simple behavioural interventions to overcome those deeply engrained and indiscriminate behavioural biases that prevent savings levels rising to wholly more appropriate levels. Aside from compulsion going against the more libertarian ethos of contemporary pensions policy,[11] in a democracy people generally don't like being explicitly told what to do with their own money. By contrast, overcoming the cognitive barriers to increasing DC contribution levels by moving people gently towards more optimal behaviour is a more subtle and surreptitious approach to achieving desired outcomes.[12] Moreover, when applied correctly, these interventions can focus on both the disengaged, those who can't or won't help themselves (think auto enrolment), *and* support the active engagement of those capable of helping themselves if given an easy and emotionally accessible opportunity to do so. The latter is facilitated by the EAST framework of making actions and prompts *easy* (removing the "hassle factor" associated with performing the desired action, e.g. requiring just one click), *attractive* (using personalisation, simple and positive language and visuals, appropriate media and novel incentives to make a course of action appealing), *social* (creating positive social norms by socialising desirable actions and behaviours) and *timely* (prompting individuals to change behaviours at those pivotal times in their lives when they are most receptive to engagement).[13]

The most prevalent and destructive of these cognitive barriers to overcome are *present bias* and *anchoring*. Present bias is the, typically strong, preference for consumption today over deferring consumption, by saving, until tomorrow. Indeed, for many, retirement is too far away to be relevant to their decision making today, not least because individuals find it difficult to visualise themselves in later life. So the savings decision effectively becomes a choice between spending on yourself today versus saving for a stranger to spend *your* money in the future. This is compounded by the tendency of many pension savers who mentally anchor[14] their pension contributions to either the automatic enrolment minimum contribution level or that applied by their workplace pension scheme in the mistaken belief that these have been endorsed, by the government or their trusted employer respectively, as being adequate to provide a comfortable retirement.
The reality is, of course, so, so different.

Overcoming present bias and anchoring

Present bias can be overcome by better aligning the immediate costs and future benefits of saving by a combination of making the costs appear less immediate and the benefits more immediate and salient.
For instance, projecting an image of how someone might look 30 or 40 years from now dramatically improves their engagement with retirement planning,[15] not least because they can identify with their future self and how many of today's activities and expenditures they will continue to enjoy far into the future – so making the benefit of saving more salient. The *Save More Tomorrow* approach of automatically escalating DC member contribution rates is another such initiative. Here, DC savers commit today to paying increased contribution levels *only* in the event of receiving future pay rises. By not having to pay any money today, the individual delays this cost while ensuring that their future is better catered for.[16] Then there's issuing a national lottery ticket for, say, every £100 per month saved. Lottery prizes are attractive in that people tend to focus on the prize (indeed, visualise themselves sitting on a big pile of cash) rather than the small probability of winning it.[17] In addition to better aligning the immediate cost of making a higher monthly contribution with a potentially much larger immediate benefit, introducing lottery tickets can also help to move contributions away from the minimum contribution "anchor".

Lottery tickets aside, anchoring is typically addressed by using simple language, positive words, attractive framing and by expressing actions in pounds and pence rather than percentages. Simple messaging such as, "save three days' salary per month" or "save your age multiplied by 10 per month" resonates with people and is instrumental in moving the contributions "anchor" to a more realistic level.[18] Another is reframing pensions tax relief as a "savers bonus", and using sufficiently, but not unpalatably, large numbers to illustrate how the bonus works, e.g. a £50 bonus is received for every £200 saved. Likewise, positioning employer contributions, especially those that match or escalate at a faster rate than employee contributions, as "free money", again encourages employees to move beyond the minimum contribution rate.[19]

[10] However, despite conventional wisdom, educating adults on pensions typically has little, if any, long-term effect in changing behaviour. This is principally because contemporary behaviours, habits and choices are largely informed by and anchored to early life upbringing and experiences. The exception to this is *just in time education* imparted at those pivotal moments when people are most receptive to engagement.
[11] As embodied in auto enrolment and freedom and choice.
[12] One particularly successful subtle behavioural intervention has been auto enrolment, which in using the inertia associated with getting people to save into a pension, requires them to opt out, rather than opt in. See: Mind the gap: Overcoming the cognitive barriers to saving for retirement. Chris Wagstaff. Columbia Threadneedle Investments. 2016. https://www.columbiathreadneedle.co.uk/media/10116793/en_mind_the_gap_paper_two.pdf
[13] See: EAST. Four simple ways to apply behavioural insights. The Behavioural Insights Team. 2014.
[14] Anchoring is when people latch onto a wholly irrelevant number that comes easily to hand when they are in unchartered territory and use it as a reference point in their decision making.
[15] See: Hal E. Hershfield, Daniel G. Goldstein, William F. Sharpe, Jesse Fox, Leo Yeykelis, Laura L. Carstensen, Jeremy N. Bailenson. Increasing Saving Behavior Through Age-Progressed Renderings of the Future Self. Journal of Marketing Research Vol. XLVIII (November 2011), S23–S37. http://vhil.stanford.edu/mm/2011/hershfield-jmr-saving-behavior.pdf.
[16] See: Richard H. Thaler, University of Chicago and Shlomo Benartzi, University of California, Los Angeles. Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving. Journal of Political Economy, 2004, vol. 112, no. 1, pt. 2.
[17] This probability insensitivity is called the affect effect.
[18] *Golden Rules of Communication. Talking about pensions with a new generation of savers*. NEST. 2014.
[19] For more detail on how behavioural interventions can be used to overcome the key cognitive biases that prevent greater levels of saving, see: Wagstaff (2016). Op.cit, https://www.columbiathreadneedle.co.uk/media/10116793/en_mind_the_gap_paper_two.pdf

Why does all of this matter?

Addressing the inadequacy of retirement provision, partly as a consequence of sub-par DC contribution rates, remains one of the UK's biggest socio-economic challenges. Indeed, the aspiration to generate good financial outcomes at and in retirement typically fails to meet the reality by some margin judging by current and projected future income replacement rates.

When applied correctly, behavioural interventions have the capacity to motivate greater levels of retirement saving and ultimately move the nation towards achieving good financial outcomes. It is also a more palatable policy tool than compulsion. However, behavioural interventions, while effective, are best applied not in isolation but in conjunction with people being properly supported throughout the entire retirement planning and implementation process. In so doing, people will feel empowered to make better and more informed decisions and so move the nation closer to addressing the inadequacy of retirement provision.

To find out more visit columbiathreadneedle.com

Issued 02.21 | Valid to 12.21 | J3359 | 3442797