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PENSIONS WATCH – ISSUE 12: WHAT'S BEEN HAPPENING AND WHAT'S ON THE HORIZON IN THE WORLD OF PENSIONS

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With the recent launch of the 7th annual edition of the Pension Policy Institute's (PPI's) The DC Future Book,[1] compiled, as it has been since its inception, in association with Columbia Threadneedle Investments, we look at the key findings of this year's research and what actions should be considered if good retirement outcomes are to become the norm.

The DC Future Book

2021 sees the publication of yet another highly informative edition of *The DC Future Book*, the 7th in the series, underpinned by the PPI's fiercely independent approach to Defined Contribution (DC) research. The DC Future Book continues to promote a better understanding of trends and themes in the UK DC pensions market and as always, there are plenty of facts and figures to pique the interest of even the most experienced DC practitioner. So, what are the key findings of this year's research and what actions should be considered if good retirement outcomes are to become the norm?

The state pension

The state pension, the first pillar of the UK pension system, inevitably comes under the spotlight, as increases to State Pension age (SPa) continue to lag improvements in longevity and a deteriorating dependency ratio.[2] This, coupled with the triple lock, introduced in 2010 and unique to the UK in striving to restore the real value of one of the world's least generous state pensions,[3] continues to ratchet up the cost of state pension provision.[4] Although, in stark contrast to just 35 years ago, to be a pensioner today doesn't, on average, mean living in *relative poverty*,[5] for many in retirement the state pension is their main or sole source of income and will increasingly become the mainstay of most retirement outcomes.[6] Therefore, as the needs versus cost debate remains finely balanced, perhaps it's time to revisit the future trajectory of SPa and the viability of means testing the state pension – just as the *old age pension* was when introduced in 1909.[7]

Auto enrolment

The PPI notes the rapid decline in private sector active Defined Benefit (DB) participation, currently at 1.1m, continues unabated, while active DC membership, at 13.7m, greatly assisted by the success of automatic enrolment (AE), hits successive highs. However, despite 10.5m people[8] having been auto enrolled into an occupational pension scheme since 2012 and almost 1m re-enrolled, a not insignificant 10.1m of the UK's employed population are now ineligible for AE as a result of their age and/or level of earnings – with a disproportionate number of these being women. Not to mention the nation's 4.4m self employed, who are also excluded, few of whom have any notable pension provision.[9] Indeed, despite The Pensions Commission in 2004

[1] https://www.columbiathreadneedle.co.uk/uploads/2021/09/af7e410d8cb1d916c48551173e179070/en_20210923-the-dc-future-book-2021-final.pdf

[2] The (old age) dependency ratio is a country's dependent population expressed as a percentage of its total working-age (aged 15-64) population. According to the World Bank, for the UK this stands at 29.3%, against 14.3% for the world. See: https://data.worldbank.org/

[3] Having been designed to provide no more than a basic standard of living in retirement, the full single tier state pension has a post-tax replacement ratio of 28.4%, i.e. of pre-retirement income, for the median UK earner. OECD (2019), Pensions at a Glance 2019: OECD and G20 Indicators, OECD Publishing, Paris. p.155.

[4] The triple lock will be suspended for 2022/23, during which the state pension will be uplifted by the greater of CPI or 2.5%.

[5] According to the government's annual Households Below Average Income (HBAI) survey, relative poverty is defined as household income falling below 60% of the median UK household income. To be a pensioner 35 years ago in almost any OECD country typically meant living in relative poverty. However, in the UK, we have moved from a position where, 35 years ago, pensioners were at least three times as likely to be poor as non-pensioners, to one where since 2011 median pensioner incomes now exceed median non-pensioner incomes. Source: OECD (2015), Pensions at a Glance 2015: OECD and G20 indicators, OECD Publishing, Paris. http://dx.doi.org/10.1787/pension_glance-2015-en. Figure 1.3. p.18. That said, the UK has an above average old age poverty rate. This metric defines the percentage of those aged over-65 whose income is below the national median income. The UK's old age poverty rate stands at 15.3%, against an OECD average of 13.5% and a poverty rate of 11.9% for the UK as a whole. Moreover, a gender pensions gap also exists in this metric with 17.7% of women aged over 65, versus 12.5% of men, caught in the old age poverty trap. The OECD average of 13.5% is split 15.7% for women and 10.3% for men. See: OECD (2019). op.cit.p.187.

[6] The Ski-Slope of Doom – Is this the most worrying chart in pensions? Sir Steve Webb. LCP. April 2021. Also see: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-8/

[7] In 1909, the old age pension, as it was then known, was paid from age of 70 to anyone whose income was less than £21 per annum, reducing to zero if that income exceeded £31.

[8] At 30 June 2021.

[9] According to Pensions Bee, "the self-employed in the UK are the least well-prepared for retirement, and risk being left dangerously exposed to poverty in later life." See: How does the gig economy affect pensions? Laura Miller. Pensions Bee. 10 December 2019.

suggesting that if you're working you should be contributing to a pension[10] and 2017's Auto Enrolment Review calling for reform to dramatically increase AE coverage,[11] ineligibility has continued to rise and the Department of Work and Pensions (DWP) has yet to act.

Indeed, the PPI estimates that by reducing the entry age for AE from 22 to 18 would increase eligibility by 700K, while extending the £10K earnings floor from single to multiple jobs would boost eligibility by about a third (3.5m). The report is also explicit about the inadequacy of minimum AE contributions, at 8% of band earnings – with PPI analysis suggesting that a contribution rate of 20% of median earnings should provide for a more comfortable standard of living in retirement for the median earner. Of course, the question remains as to whether £10K is an appropriate AE entry point and whether calculating contribution rates on band earnings (£6,240-£50,270 for 2021/22), rather than from the first pound of earnings, will compromise good retirement outcomes for low to median earners. Indeed, as Sir Steve Webb points out in his *Ski Slope of Doom* paper, from earlier this year, we're almost at peak DB pension rights, with DC, in the continued absence of materially and sustainably higher contribution rates, proving to be a very poor substitute for DB.[12]

In order to avoid retirement penury becoming the norm, we should also keep a watchful eye on AE opt out rates which, pre-pandemic consistently hovered around 9%, and pension saving persistency rates,[13] which while healthy at 70%, had started to dip pre-pandemic, especially in the public sector. Neither statistic has yet factored in the full impact of the pandemic.

Master trusts

The report notes that the popularity of master trusts continues unabated, especially as employers' medium of choice for AE. Indeed, 84% of employers now use master trusts for AE – with the number of pension savers in master trusts projected to rise from 8.7m today to 10.6m in 2041.

Median pot sizes

Intrinsically linked to AE are median DC pot sizes. Although at £11,400, the 2020 median pot size represents a near-20% increase on 2019 (given the higher AE minimum contribution rate from 2018 flowing through to pension pots and pension savers having had another year to build up their pots), sub-par median pot sizes remain concerning. Likewise, the dramatic increase in the projected number of small, expensive to manage, deferred DC pots. However, pot consolidation is likely to accelerate once pension dashboards begin to appear. Although median DC pots at SPa are forecast by the report to grow from £38K today to £63K in 2041 (in 2021 money terms), this might still be insufficient to support a comfortable standard of living considering the ever greater reliance on DC pots in retirement.

Asset allocation

The PPI's annual DC Asset Allocation survey continues to grow in stature, providing us with ever greater insight into the investment strategies run on behalf of c.20m DC members. It's reassuring to see healthy levels of active management and increasingly greater diversification of default fund asset mixes, though there's still a way to go in embracing more governance-intensive and genuinely diversifying less liquid asset classes, given the positive cash flow and ultra-long investment horizon of most DC schemes.

Accessing pension pots

At 277,500, the report notes that the number of DC pots accessed in 2020 declined by 36% on 2019, suggesting that savers were, understandably, cautious about accessing savings during a period of uncertainty. A recurring theme remains the dwindling numbers, of those at retirement, seeking independent financial advice before purchasing an annuity or income drawdown, at 19% and 42%, respectively. However, there are still consistent numbers using *Pension Wise* – the government's free-to-access pensions guidance service for those aged 50+. While, in an ultra-low interest rate environment, it's perhaps unsurprising to see annuity sales, at 49K in 2020, falling to an all time low and drawdown sales, at 94K, remaining relatively buoyant, a near halving of full cash withdrawals, to 134,500, contrasts with a sizeable minority making regular unsustainable withdrawals from drawdown pots.[14] However, the average entry size, in 2020/21, of annuities at £71K, £77K for drawdown and £15K for full cash withdrawals, is fairly consistent with 2019/20 numbers.

DB transfers

On DB transfers, the report highlights that almost 3K people (8% of those using an IFA) insist on transferring their DB benefits to a DC fund when advised by an IFA not to do so. Potentially one for the FCA to revisit.

Aggregate DC assets

The report suggests that aggregate UK DC assets could double from £490bn today to £995bn in 2041, a number that could well rival the size of aggregate DB assets in 20 years time. After all, private sector active DB membership is forecast by the report to fall from 1.1m today to 400K in 2041, not to mention the number of transfer values and the aggregate amount of pension payments that will have been paid out over next 20 years.

[10] https://www.instituteforgovernment.org.uk/sites/default/files/pension_reform.pdf
[11] https://www.gov.uk/government/publications/automatic-enrolment-review-2017-maintaining-the-momentum
[12] Webb (April 2021). op.cit.
[13] Persistency rates measure the proportion of people automatically enrolled who contribute regularly into their pension. The DWP tests the proportion of eligible employees contributing into a workplace pension for a period of at least three out of four years.
[14] In 2019/20, 42% (up from 40% in 2018/19) of those making regular withdrawals from drawdown or Uncrystallised Fund Pension Lump Sums (UFPLS) withdrew at annual rate of 8% or more and nearly three quarters withdrew at a rate of at least 4%.

The pandemic and DC investment strategies

Finally, as the DC world continues to evolve, not least against the backdrop of the global pandemic, the thematic chapter of this year's publication shines a spotlight on both the immediate and prospective future impacts of the Covid-19 pandemic on the ever increasing population of UK DC pension savers and on DC schemes' investment strategies.

The DC Future Book notes that thanks to the quick thinking of governments and central banks, the world avoided what would otherwise have been a global economic calamity with deep seated consequences for the UK's burgeoning band of DC pension savers. As it proved, this quick thinking meant that many risk assets bounced back with unparalleled speed,[15] some markets even surpassing pre-pandemic levels. Taken in combination with schemes' long-term investment horizons, hence a reluctance to make significant changes to underlying asset mixes during the period of heightened volatility, meant that most DC savers have emerged from the depths of the pandemic less impacted than they might otherwise have been. However, had the economic and market downturn been deeper and more protracted, the governance challenges of a number of DC schemes would have undoubtedly been exposed, resulting in the acceleration of DC scheme consolidation and much improved governance. The PPI also notes that the pandemic has, in some instances, presented opportunities for informed investors[16] and brought to light a heightened awareness of Environmental, Social and Governance (ESG), risk factors, particularly around social issues such as health and labour practices. This shifting emphasis among investors highlights how rapidly ESG issues can evolve, underscoring the importance of schemes being both proactive and flexible in their approach to responsible investment considerations.

However, the report concludes that now is not the time for complacency. With the ever present threat of, largely unforecastable, future market shocks, or *black swans*, lurking on the horizon, DC schemes should assess the robustness and resilience of their default funds, in particular, by risk factors and return drivers, by conducting the scenario analysis more commonly associated with DB schemes.

Why does this matter?

The DC Future Book explicitly recognises that, having moved from a system of generous pension provision, collective passivity and certain outcomes, where everything was *done* for you (DB), to one that is increasingly less generous, with individual responsibility and less certain outcomes, where everything is *down* to you (DC), addressing the inadequacy of retirement provision is fast becoming the UK's biggest socio economic challenge.

Aside from being a valuable reference document and an invaluable source of DC thought leadership and of informed debate and discussion, in reaching out to *all* stakeholders – policymakers, regulators, providers and practitioners – *The DC Future Book* is also a catalyst for change. In particular, the report implicitly recognises that, with continued policy inaction, a whole generation of people are potentially facing a worsening retirement outlook. This includes many of the nation's 4.4m self-employed, who increasingly operate in the gig economy, with its meagre pensions uptake and, of course, those 10.1m employees likewise excluded from AE by virtue of their age and/or their salary not meeting the £10K minimum. Moreover, even those who do meet the AE criteria or who participate in other qualifying pension schemes simply do not, on average, save enough to generate a moderate, let alone a comfortable, standard of living in retirement. This is evident from current and future projected median DC pension pot sizes. Then there's the dwindling numbers using independent financial advice when accessing their pots.

Of course, while the disproportionately central role likely to be played by the state pension should prevent a deepening of the UK's above average old age poverty rate, a lack of decisive action means far too many people, on current trajectories, are set to unwittingly sleepwalk into retirement penury and endure, rather than enjoy, a retirement after a lifetime of work. While the motivation and means exists to generate better retirement outcomes for today's 20-, 30-, 40- and even 50-somethings, what appears to be missing is the will to develop a better framework. Moreover, this framework could draw more extensively on good behavioural science to arrest the seemingly imminent decline in retirement living standards, by helping to guide people towards making more optimal decisions to and through retirement.[17] In other words, whether a basic, moderate or comfortable retirement becomes the norm, is largely contingent on timely and decisive action or continued inaction.

[15] For example, following a c.30% decline in March 2020, equity markets returned to their pre-pandemic levels in just five months, in contrast to the typical 12/18 month recovery period for previous market downturns of this magnitude.
[16] In periods of rapid change, i.e. when new information is emerging, typically under conditions of considerable uncertainty, i.e. when that information is difficult to interpret, significant deviation from efficient market pricing is more likely, as investors attempt to adjust, or adapt, to the new investment environment, i.e. markets conform to the adaptive markets hypothesis.
[17] See: Pensions Watch editions 6 and 8 at: https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-6/
https://www.columbiathreadneedle.co.uk/en/inst/insights/pensions-watch-issue-8/

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