Assessing the key challenges in DC

Five years of auto-enrolment

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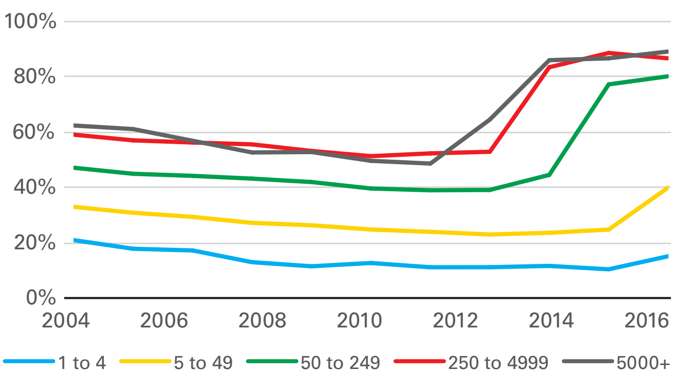
October marked a significant milestone in DC: five years since the beginning of auto-enrolment. However, it's important that asset managers and pension providers don't lose sight of the key challenges facing both pension schemes and savers.

In this paper we examine what auto-enrolment has achieved so far and review the behavioural and structural challenges that remain for savers and schemes. We also explain why we think next year's phasing of contributions is unlikely to result in a significant increase in opt-out rates, and discuss how pension schemes can empower their members to meet these pension challenges head on.

Figure 1. Trends in workplace pension participation by private employer size



Source: DWP

WHAT HAS AUTO-ENROLMENT ACHIEVED SO FAR?

Auto-enrolment has brought millions of employees into private pensions for the first time: workplace pension membership rates among eligible private sector employees of medium and large employees increased dramatically from around 50% in 2012 to 80-90% in 2016[1]. There are now over six million private sector employees enrolled in defined contribution schemes.

At the start of auto-enrolment there were fears that opt-out rates would be high, but this hasn't materialised. As an example, the current opt-out rate within LGIM administered schemes is around 9%.

Awareness of auto-enrolment is also at very high levels, with more than 80% of employees interviewed knowing about auto-enrolment in a recent Office for National Statistics survey[2]. This has risen dramatically over the past five years.

1 DWP, "Official Statistic on workplace pension participation and saving trends of eligible employees: 2006-2016"

2 ONS, "Early indicator estimates from the Wealth and Assets Survey: attitudes towards saving for retirement, credit commitments and debt burden, July 2016 to Dec 2016"

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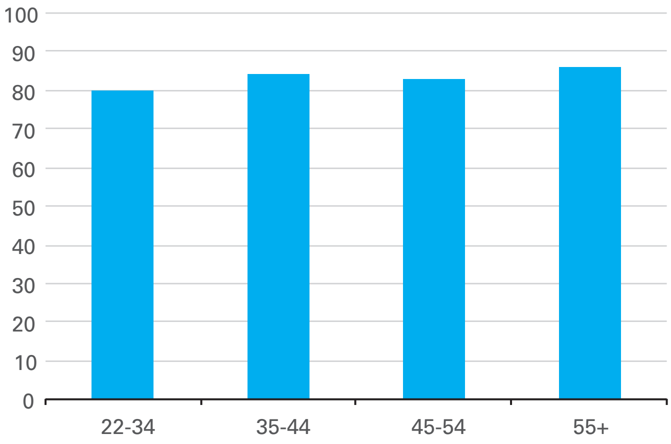
Looking forward, employers of all sizes are due to be covered by February 2018, which will mark the completion of the phasing initiated in 2012. This should see even more savers enrolled, capturing small businesses and the self-employed.

Figure 2. Percentage of interviewees aware of auto-enrolment



Source: ONS

WHAT ARE THE KEY CHALLENGES FIVE YEARS ON?

Whilst the overall implications of auto-enrolment are likely to be net-positive for individuals without sufficient savings, businesses and public finances, there are still crucial structural and behavioural challenges that remain for all key DC stakeholders.

Insufficient levels of saving

Much has been written about how these are difficult times for pension savers. The long-term transition away from defined benefit schemes, combined with stagnant wage growth and increased life expectancy are all part of the demographic challenges that LGIM have discussed in detail in our Long-term Thinking. This means that savers of all ages and stages can find it challenging to plan ahead for the kind of retirement they desire.

The combined minimum paid into a pension by employer and employee is set to rise from 2% of a band of earnings to 5% in 2018 and 8% by 2019. This is a more positive backdrop for individuals, particularly those who had not made any pension provisions prior to auto-enrolment. It is also much needed positive news for finances of the UK government, who may no longer need to bear the full cost of supporting insufficiently-funded retirees through welfare and public services.

However, this will not in itself be sufficient to bridge the savings gap, which exists for many pension savers. A recent study by the International Longevity Centre-UK concluded that young workers in the UK will need to save 18% of their earnings each year in order to secure an adequate requirement income.

How can pension schemes help?

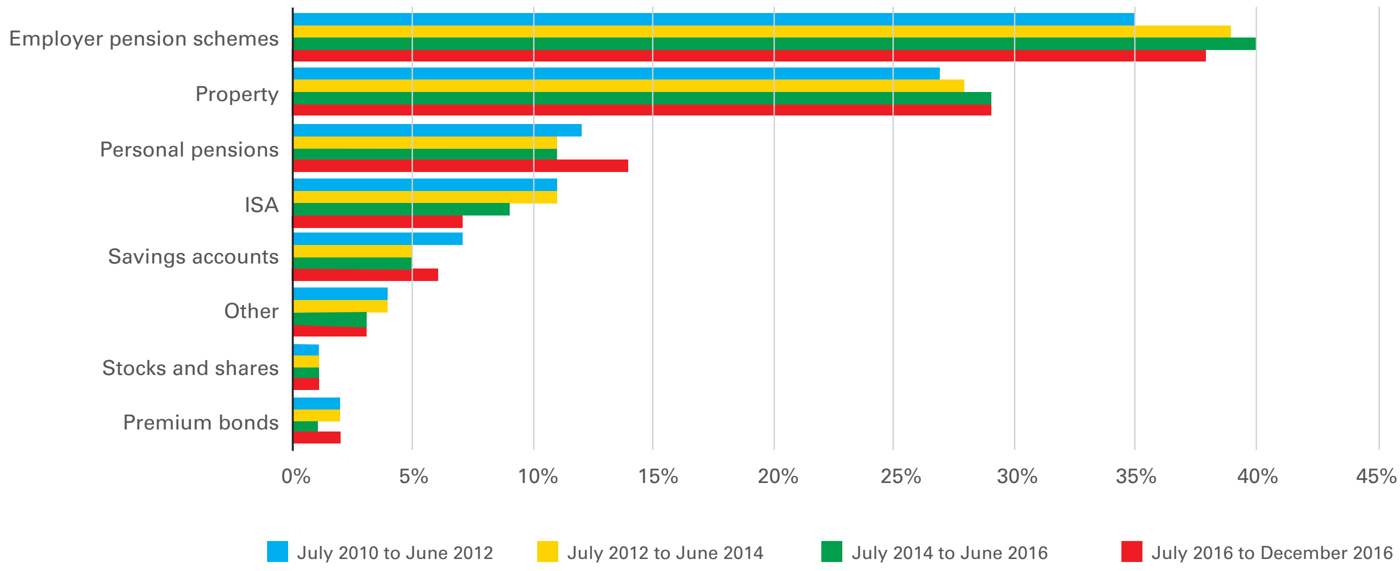
Good investment performance is extremely important for investor outcomes, so making sure your scheme reviews the default regularly and assesses its value for money should help achieve better outcomes. However, this alone may not be enough. Explaining the value of workplace pensions and making it easier for employees to increase their contributions may help members achieve more comfortable levels of retirement income.

Multiple retirement savings vehicles and increasing demands on savers' income

With high housing values making it harder to save for a deposit, not to mention the other everyday calls on money, it's widely known that many prioritise capital for the short and medium term ahead of important additional retirement savings contributions.

What is perhaps less widely appreciated is that there is a significant lack of consensus among those who are retirement savers as to the best saving vehicle for the job. While pensions are viewed as the safest choice, there is a large contingent of the population who favour other options such as property, ISAs, saving accounts and premium bonds. Furthermore, the rise of auto-enrolment has not led to material change in this over recent years (*Figure 3*).

Figure 3. Survey: what's the safest way to save for retirement?



Source: Office for National Statistics[3]

How can pension schemes help?

Employees may benefit from additional education on benefits of workplace pensions, highlighting generous tax breaks offered by the government with DC pensions, as well as the power of matching company contributions. More flexibility to increase and decrease additional pension contributions may help members to balance pension needs and other calls on their money.

Perception of pensions as a cost and potential rise in opt-out rates

In an environment where wages are squeezed and the cost of everyday living is a challenge for savers, some individuals may perceive contributions as a cost rather than a benefit.

In addition, as minimum contributions from employees are set to increase from 1% to 3% in 2018 and 5% in 2019, there are fears that this may trigger new opt-outs, as people notice their pay checks decreasing. Some opt-outs may be inevitable, yet there are also reasonable grounds for optimism: awareness of pensions has risen dramatically over the last five years and 'Freedom and choice' pension reforms increased savers' sense of ownership over their pensions.

More importantly, auto-enrolment's reliance on opting out rather than opting in has previously yielded better than expected results, which is consistent with its behavioural economics theory as well as results for similar choice designs. In the UK, at the start of auto-enrolment the DWP's original estimated opt-out rates of 28%, whereas the realised opt-out rates for larger employers have turned out to be between 8% and 14%[4].

Another example will be the "Save more tomorrow" pension design in the US created by Richard Thaler, the winner of 2017 Nobel Prize in Economics. In one of the schemes who adopted the design, out of 162 participants who enrolled into automatic pension contributions increases only 3 opted out after the first increase and 23 after the second[5].

In a recent qualitative study of auto-enrolment in small and micro employers, the DWP concluded that workers who remained in their workplace pension spent very little time considering whether to opt out and would typically consider automatic enrolment a good idea. Moreover, they "appeared relatively relaxed about the first stage of phasing (the increase from 1% to 3% worker contribution), having seen that the impact on their take-home pay has been low so far."[6]

3 https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/articles/earlyindicatorestimatesfromthewealthandassetssurvey/attitudestowardssavingforretirementautoenrollmentintooccupationalpensionscreditcommitmentsanddebtburdenjuly2016todec2016

4 National Audit Office – "Automatic enrolment to workplace pensions", 2015 https://www.nao.org.uk/report/automatic-enrolment-to-workplace-pensions/

5 Professional Pensions "How 'Save More Tomorrow' programmes work", October 2017

6 "Automatic enrolment: qualitative research with small and micro employers", DWP, October 2017

Additional help could come in the shape of planned personal tax thresholds increases: the personal allowance for 2017/18 is set to increase from £11,000 to 11,500 and the higher rate threshold from £32,000 to £33,500. This should cushion the effect on the take-home pay.

How can pension schemes help?

Although we do not expect much higher opt-out rates, reminding your members of the pension contribution rate increase and at the same time highlighting the benefits of workplace pension may help them to prepare for changes and avoid surprises when these changes come.

HOW CAN WE ADDRESS THESE CHALLENGES?

We believe one of the key ways that investment managers, pension providers and pension schemes can help to address these challenges is by boosting engagement with pensions and via broader financial education and better member communications.

In addition, providing online tools can help members see the value of their assets and project their expected retirement income. This can serve as a reminder of both the value of saving, and the important role that contributing to pensions can play in adapting to both the structural and behavioural challenges facing DC scheme members.

Another aspect that pension schemes can choose to highlight is how much companies and pension schemes can help DC investors to save for their retirement, not just via company contributions, but also through getting better governance, better value for money, and a range of investment options including a well-selected default fund. Indeed, investment outcomes are key to good retirement outcomes, with high-quality, long-term focused and cost-aware investment funds crucial to help DC investors to achieve the retirement they want.

The bottom line therefore, is that while auto-enrolment has proved a success, the journey into the new DC landscape has only just begun. There are no shortages of challenges presenting themselves for both schemes and members. However, we believe that clear communications can make a real difference when facing these challenges by highlighting the potential benefits of higher contributions, better investment outcomes, and robust investment governance. We'll discuss each of the three factors in future papers.

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