DC scheme default strategy policy considerations

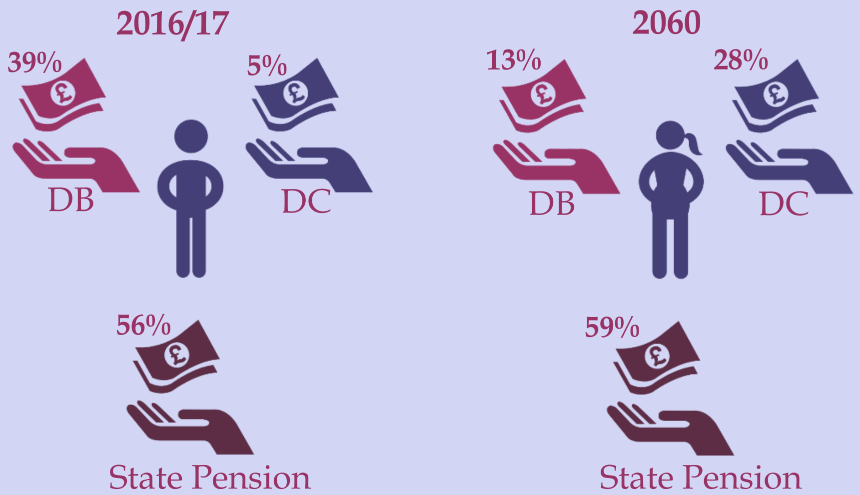
Introduction

Future pensioners will receive the largest proportion of private pension income from Defined Contribution (DC) pensions. As the majority of DC members are saving in their scheme's default strategy, trustee and provider decisions regarding how to structure these strategies will have a substantial impact on future pension incomes. However, in the wake of Freedom and Choice and the influx of new savers who have been automatically enrolled, the considerations which need to be taken into account when constructing default strategies have changed.

This is the second of two Briefing Notes looking at DC scheme default strategies. The first Note looked at how well the objectives of DC pension schemes' default investment strategies meet the needs of their membership. This Note outlines the current considerations and policy debates relevant to DC scheme default strategies and covers how:

- Default strategies are changing after Freedom and Choice.
- Investment in illiquids and alternative assets could benefit default strategies.
- Membership characteristics may affect the most appropriate default strategy.
- Retirement pathways could play an important complementary role to default strategies.
- Consideration of Environmental Social and Governance (ESG) factors could involve increased implementation and assessment costs, but may also result in more secure, long-term returns.
- Consolidation could reduce charges and increase the accessibility of illiquid assets for default strategies.

Figure 1: Average income from State and private pensions by year (includes private and public sector)



A default strategy is the investment strategy that members will automatically have their contributions invested in, unless they make an active choice to invest in a different strategy.

The majority of future private pension income will come from Defined Contribution savings

Defined Benefit (DB) schemes have dominated the private pensions marketplace for several centuries; however, a recent decline in the proportion of open private sector DB schemes coupled with the automatic enrolment of more than 10 million workplace pension members between 2012 and 2018, has resulted in the number of active DC savers overtaking the number of active DB savers. In 2018 around 13.1 million people were actively saving in a DC pension compared to around 7 million active DB savers (including the public sector).[1]

In 2016/17 DB pensions provided 39% of average pension income, and DC provided 5% of average pension income, the remaining 56% came from State Pension and benefits.[2] However, future pensioners will receive the majority of private pension income from DC pensions. In 2060, pensioners are projected to receive around 28% of pension income from DC pensions compared to around 13% from DB, on average (Figure 1).[3] While the majority of future private pension income is projected to come from DC pensions, the average amount that people receive from DC pensions in future is likely to be lower than the average amount that pensioners receive from DB pensions today.

The decisions that DC savers, employers, trustees and providers make today will have a substantial impact on future pension incomes.

Default strategies will play a role in future outcomes from DC saving

The financial outcomes from saving in a DC pension depend on many factors including, but not limited to: charges, contribution levels, economic and market forces, timing and method of withdrawal. Aside from these factors, the management and implementation of the default strategy in a DC pension scheme, (in which 84% - 99% of members are saving, depending on scheme type)[4] could significantly impact on members' financial outcomes.

Many schemes have traditionally used a "lifestyle" model for their default strategy

Until recently, the majority of those saving in a DC pension scheme were expected to take a 25% tax free lump sum at retirement, and use the remainder of their savings to purchase a lifetime annuity. As a result, most default strategies deployed a lifestyle (or target date fund) approach which protects a members' savings in the years prior to an annuity purchase, when there may not be sufficient time to make up significant losses through further investment or contributions.

Lifestyling reduces volatility as members age, through investing the majority of a members contributions in high volatility assets, such as equities, until around 10 to 15 years prior to a members selected retirement date after which time contributions are gradually shifted to lower volatility assets such as cash and bonds.

Reductions in annuity purchases mean that lifestyling may no longer be the most appropriate default strategy for the average member

From April 2015, as a result of the introduction of "Freedom & Choice", people are no longer required to purchase a secure retirement income product in order to access their DC savings. Consequently, sales of annuities have decreased and income drawdown sales have increased. Between 2009 and 2017, annuity sales dropped from 466,000 per year to around 40,000 per year. Drawdown product sales rose from around 40,000 per year in 2014 to around 100,000 per year in 2017. People also took 240,000 full cash lump sums withdrawals in 2017 (figure 2).[5]

A lifestyle strategy, designed on the assumption that members will use their savings to purchase an annuity, may be unsuitable for DC pension savers who wish to continue investing their savings because a de-risking strategy, which aims to reduce volatility, also reduces the opportunities for funds to realise high returns.

However, many DC schemes continue to employ lifestyling for their default strategies. This is partly because, post Freedom and Choice, there is no widely recognised "appropriate default strategy" for DC members, as lifestyling used to be. However, some DC schemes have changed their default strategy in the wake of Freedom and Choice.

Investment in illiquids, alternative assets and diversified funds provide potential alternative to lifestyling, which may be appropriate for a variety of DC access options

For those who wish to reinvest DC savings into a drawdown product or another investment vehicle, a lifestyle strategy could result in missing out on returns which they would have otherwise been able to benefit from if their contributions had remained in more volatile assets. However, a default strategy which involves retaining contributions in asset classes with high volatility may not be appropriate for those who do wish to purchase an annuity, for whom capital preservation will be a key priority. Although this strategy does forgo some opportunities for funds to earn high returns. A compromise, in which funds could be protected from significant losses, but also remain exposed to returns would constitute a reason-

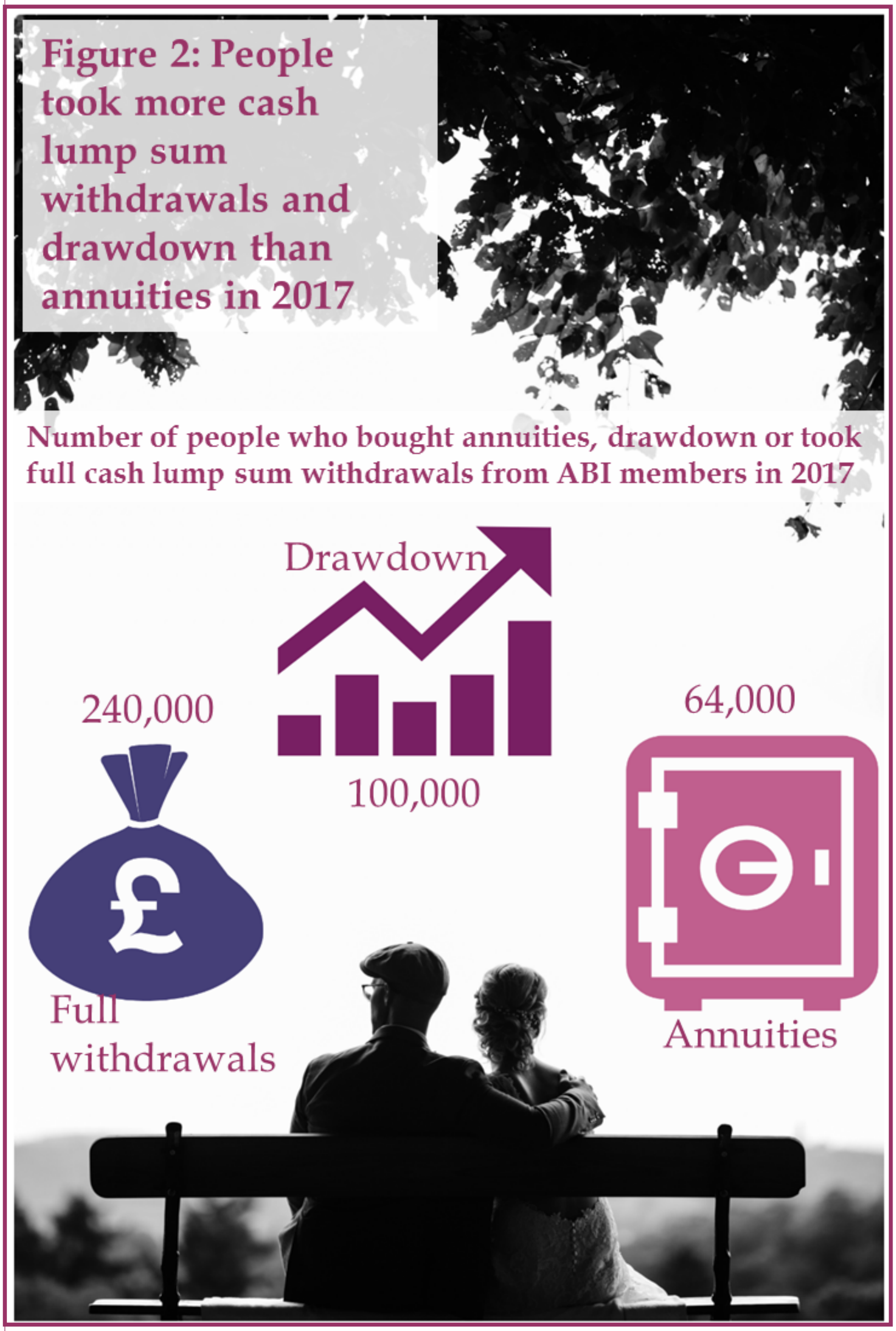


Figure 2: People took more cash lump sum withdrawals and drawdown than annuities in 2017

able compromise.

Illiquid and alternative assets generally provide a more stable rate of return, higher than those earned from bonds but generally lower than equities in the short term, though over time illiquids and alternatives are expected to deliver higher returns than more volatile assets.[6] DC contributions invested in these assets will not require the same level of de-risking in order to preserve capital, because illiquids and alternatives are less volatile than equities. Though, some level of de-risking may still be necessary for those who wish to start drawing an income from their pension savings.

However, there are structural and cost barriers to greater use of illiquids, and most investment platforms do not offer illiquid and alternative asset funds to DC pension schemes. The Government has been working on making investment in illiquids and alternative assets easier for DC schemes.[7] Over time, as schemes grow and regulatory change eases the way, these types of assets are likely to become more accessible to DC schemes, though the proportion of funds which DC schemes can afford to invest in illiquids will generally be limited as schemes need to preserve a large proportion of liquid capital to fund daily costs and transfers/withdrawals out.

Some schemes offer diversified growth funds which generally include some bond and equity assets while investing a portion of the fund into other less liquid and alternative assets, such as real estate, commodities and infrastructure. These funds aim to deliver a secure rate of return over time but tend to cost more than passive funds which involve equities, bonds and cash, and are not currently widely used as default strategies.[8]

Multiple default strategies could help to meet differing needs

Another approach to meeting the varying needs of DC members is by offering different strategies based on people's intended withdrawal methods. This approach allows members to have their funds invested in a way most appropriate for their intentions, but it also requires members to decide how to access savings years before they retire, when they may not be able to make a fully informed decision.

The most appropriate default strategy design differs between schemes based on membership characteristics

The design of default strategies is influenced by the provider perception of who their members are, how much risk members are willing to tolerate, their contribution levels, likely retirement choices, costs and other administrative considerations.

National Employment Savings Trust (NEST), the Master Trust scheme set up through Government loans to support automatic enrolment, target members who are likely to react negatively to early losses, by ceasing pension contributions. NEST's default investment strategy, the Retirement Fund, includes a 'Foundation' phase where funds are invested in low risk assets for five years in order to encourage saving and reduce the likelihood of members experiencing losses.[9] However, this strategy forgoes the opportunity of high returns early in the saving process and would not necessarily be suitable for those with higher risk appetites.

Other providers, for example Legal & General and Standard Life, seek to maximise returns in the early years of their default investment strategies, because they believe their membership has a higher initial risk appetite.[10]

Figure 3

Guidance and advice can help people to make better pension decisions

Not all people have the ability to optimise their outcomes from pension saving because financial capability within the UK is fairly low. For example, in 2018, 37% of automatically enrolled employees did not know they were saving into a workplace pension scheme, and 75% of all unretired UK adults had not considered much or at all about how they will manage financially in retirement.[11] However, there are support options in the form of guidance or advice.

The introduction of Freedom and Choice was accompanied by new national guidance, "Pension Wise", which offers free, independent guidance (online, by telephone or face-to face) to those aged 50 or over with DC savings.

DC pension scheme members are eligible for £500 of tax free employer arranged advice (if their employer chooses to provide this) and may take £500 from their pension pots up to three times, to use for advice.

Some organisations offer web-based "robo-advice", which is aimed at people who would benefit from advice but may not have access because they cannot afford regulated financial advice. Robo-advice uses algorithms to help answer money-based questions.

Despite the available support services, there are still people who are making retirement decisions unsupported

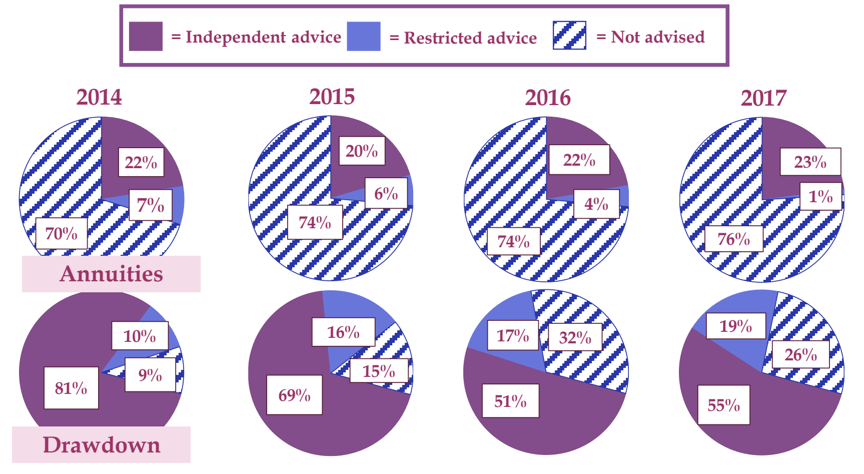
Many people are accessing their DC pension savings without support or advice.

By 2018, 20% of those accessing DC savings had a Pension Wise appointment, 46% of those accessing DC savings had received guidance from Pension Wise (through appointments, web chat or Pension Wise literature) and 7 million people had visited the website (figure 3).[12] However, this means that 64% of those accessing DC savings did not receive Pension Wise guidance, though some of these people will have received guidance from other sources and some will have received restricted or independent financial advice.

The proportion of advised product purchases has decreased since the introduction of Freedom & Choice. In 2017, the proportion of unadvised drawdown purchases was 26%, up from 9% in 2014, and unadvised annuity purchases increased between 2014 and 2017 from 70% to 76% (Chart 1).[13]

Chart 1: The proportion of advised drawdown and annuity purchases has declined since 2014

New annuity and drawdown contracts sold, 2014-2017, ABI members



ABI stats

Retirement pathways could enable better retirement outcomes

The use of retirement pathways are being considered to help people who cannot, or do not want to, make an active choice about accessing DC savings. However, default pathways which are able to adapt to unexpected changes in needs during retirement may be tricky to design. Those with multiple pension pots also pose a design challenge to prevent different pots belonging to a single person being enrolled into conflicting retirement pathways.

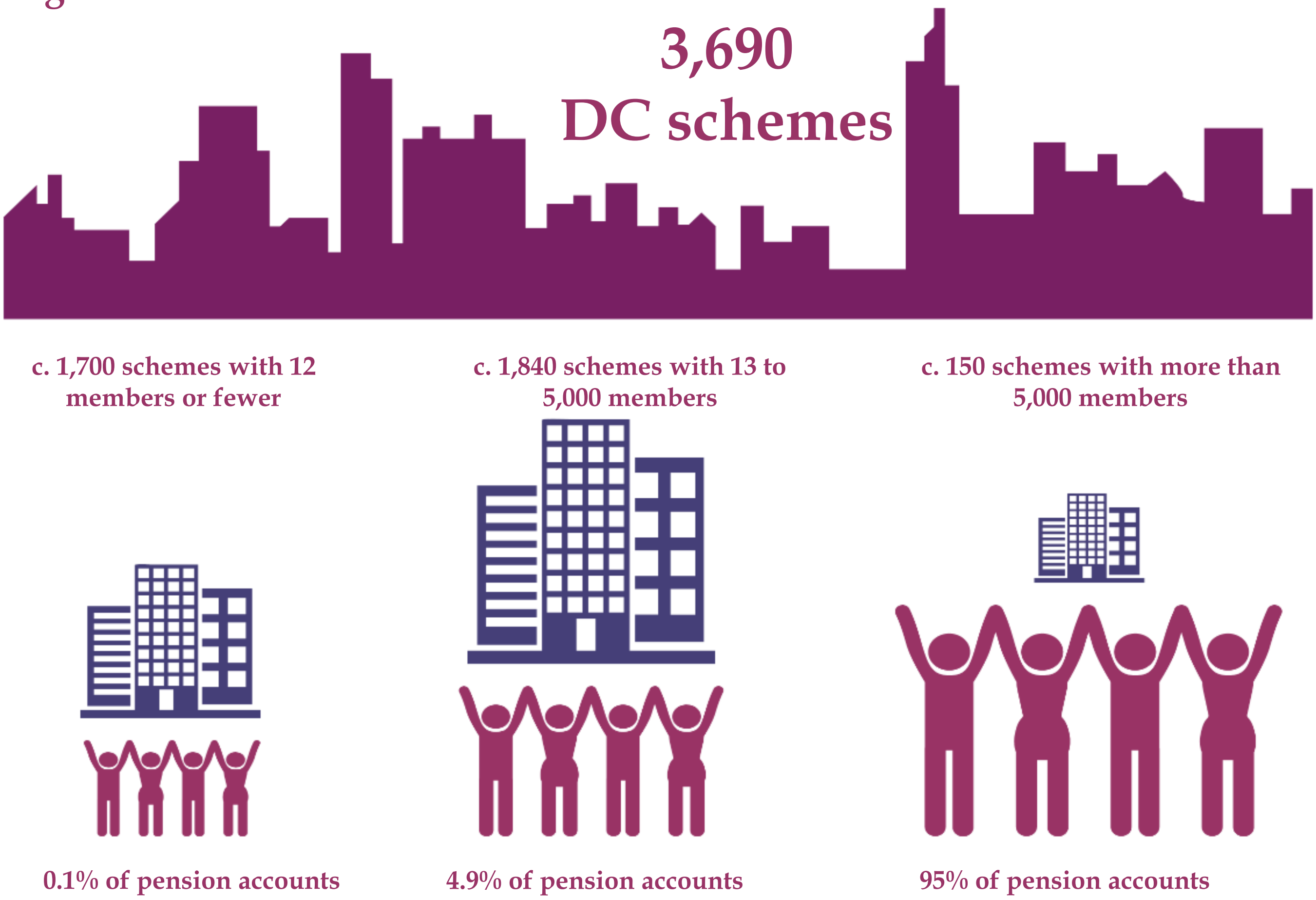
ESG factors are becoming increasingly important to consider as part of default strategies

Environmental, social and governance factors (ESG) (such as deforestation, working conditions and board diversity), can affect risk and returns (for example, poor environmental practices can lead to scarcity of required resources and poor strategic and operational decisions can lead to companies not operating at maximum efficiency).

The government has recently laid regulations which strengthen the obligation on trust-based schemes to report on how they consider ESG factors in investment decisions, including those made in default strategies. The Financial Conduct Authority (FCA) intends to consult on placing similar obligations on contract based schemes.

Pension schemes that do not integrate ESG factors into their default strategy could face legal difficulties, higher administration and legal costs as well as potentially reduced returns as a result of not taking financially material risks into account.[14] Therefore, there will be increasing pressure for providers to consider ESG factors in default investment strategies in the future. Consideration of ESG factors could involve increased implementation and assessment costs, but may also result in

Figure 4



more secure long-term returns for investors.

DC scheme consolidation could reduce charges and increase the accessibility of illiquid assets for default strategies

There are currently around 3,690 DC schemes in the UK (excluding small, self-administered pensions and executive schemes), of which around 1,700 had fewer than 12 members. There were around 1,840 DC schemes with more than 12 members (covering 99.9% of accounts) and around 150 of these schemes with more than 5,000 members comprising of 95% of pension accounts (Figure 4)[15]

Smaller schemes are generally associated with poorer governance, higher charges and risk, and generally have less capacity to diversify portfolios. For example, only 63% of medium schemes, 25% of small schemes and 21% of micro schemes identify as knowing a 'lot/quite a lot' about governance standards compared to 88% and 100% of large schemes and master trust respectively.[16]

Likewise, the use of risk registers decreases as schemes get smaller. Risk registers help pension scheme trustees, providers and sponsoring employers identify the risks to scheme funding. While all master trusts and large schemes have a risk register, the number of schemes that have a risk register shrinks to 84% among medium schemes, 39% of small schemes and 24% of micro schemes.[17]

Consolidation could have a number of beneficial effects on default strategies including:

- Reduced administrative and/or investment costs.

- Improved governance practises on a scheme and fund level.
- Increased the capacity to invest in illiquids and alternative assets.

Smaller schemes are being encouraged to consolidate by the government, and trade associations. However, consolidation reduces a scheme's ability to cater to the needs of a distinct membership group.[18]

Conclusions

In the wake of Freedom and Choice and the influx of new savers who have been automatically enrolled, the considerations which need to be taken into account when constructing default strategies have changed. This Briefing Note makes the following conclusions:

- Future pensioners will receive the majority of private pension income from DC pensions.
- A lifestyle strategy, may be unsuitable for DC pension savers who wish to continue investing their savings. However, there is no widely recognised "appropriate default strategy" for DC members.
- Investment in illiquids, alternative assets and diversified funds provide potential alternatives to lifestyling as they require less de-risking. Another approach to meeting the varying needs of DC members is by offering different strategies based on people's intended withdrawal methods.
- The most appropriate default strategy design differs between schemes based on membership characteristics.
- Many people are accessing their DC pension savings without support or advice. The use of retirement pathways are being considered to help people who cannot, or do not want to, make an active choice about accessing DC savings. However, designing a default which can cope with needs that change or with multiple pots will be challenging.
- DC schemes that do not integrate ESG factors into their default strategy could face higher costs, legal difficulties and reduced returns, but consideration of ESG factors could involve increased implementation and assessment costs.
- DC scheme consolidation could reduce charges and increase the accessibility of illiquid assets for default strategies. However, consolidation reduces a scheme's ability to cater to the needs of a distinct membership group.

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