

Roundtable

Defined contribution – a new environment

Where are we now in the transition towards good pension provision?

NIKI CLEAL: We are actually at the beginning of a journey for DC. The big change on the horizon is the introduction of auto-enrolment. All our projections and all the government's projections suggest we could see something in the region of an extra five to eight million people saving in workplace pensions in the future. That is a very substantial increase, so we are at the beginning of quite a dramatic shift in the number of people potentially saving in DC pensions in the future.

JOHN BRASINGTON: It is really interesting that for the first time people have to decide what they do with a pot of money as opposed to being given money when they retire.

ANDREW CHESELDINE: As Niki says, it is probably the biggest economic and cultural change in pension provision we have seen since the introduction of state pensions. There is an immense amount of complexity being brought back into pensions and while that may be good for consultants it is probably not so good for Joe Public. However, it does create opportunities around tax threshold management and this government has brought in annuity flexibility, which is good. However, the EU has started to intervene again, so we will have unisex annuity rates, which will cause more drive for further complexity and people opting for drawdown, males particularly. There are also some macroeco-

omic issues in terms of the EU meltdown of currencies. All of those will confuse the situation.

DAVID HARRIS: My view is it remains bleak, but I think an interesting facet is developing in the UK where more British folks now are worrying more about living too long than dying too soon. That is a stark reminder that for the individuals in this country there is a pension elite – or a pension access elite – and there are people who do not have access to pensions. A lot of people are playing on the auto-enrolment card being the panacea. I have just finished 17 days of going all around the world – New Zealand, the US, Australia – and what I will say about auto-enrolment is that opt-out rates are creeping up.

The question is does public confidence still exist in this country on pensions? My view is a little bit bleak, but I think what is encouraging – and what Jonathan has been working on among others – is the development of corporate platforms. More people in this country are thinking about non-pension savings equally and for the first time, this country is addressing that in a unified way. Indeed, it is encouraging that Washington DC bureaucrats, civil servants, and the Obama administration are looking at these core platform initiatives and are saying: "This is fantastic, we want more information about them."

JONATHAN WATTS-LAY: A lot of companies now have workforces

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with a mix of pensions either within the workforce or because employees have changed job and moved, for example, from a final salary scheme to a DC environment. This has created a lot of confusion for individuals, and the differences in benefit can have a big impact on when they can afford to retire. We did some research recently that shows employers suggested fewer than a quarter of their staff understood what retirement income options were available. They recognised the problem, but they have not done anything about it. Our worry with things like auto-enrolment coming in is that, unless you get communication working well and people educated, it will be considered akin to another tax.

STEVE MINGLE: I feel pretty pessimistic about where this journey is going to end up and whether it is likely to get folks to where they need to be. Certainly, a lot of people are in denial about the extent to which retirement ages need to increase, given not just what is being contributed into existing DC schemes but also what is going to go into the schemes of those who auto-enrol. Of course, an unwelcome side-effect of auto-enrolment may be that companies will not want to increase their overall budget on pensions, in which case it will just be spread more thinly. Good news for the folks who are now going to have something who previously had nothing, but to the detriment of

existing employees who might currently have reasonable amounts of contribution put into their schemes.

The inevitable conclusion is that we need to save more or work longer in order to thrive in retirement. I remember a spectacular headline in a newspaper along the lines of 'Now they are making us work longer' over a mooted increase to the state retirement age, suggesting it's somebody's fault we are all living longer. With attitudes and publicity like that, there is little hope of changing public perceptions of pensions for the better.

Responsibility for provision

Q We have the National Employment Savings Trust (Nest). DC is growing and the government has a role to play as well, but the communication is not joined up. So how do you start that conversation?

WATTS-LAY: I was at a company just yesterday where fewer than 50% of staff are in a pension and it employs more than 10,000 people. You can take two views: you either say, for employees who have taken the pensions they are far too generous, so the employer will level down, allowing more to join. While this will lead to an incremental cost, it will not be as big as perhaps it might have been. The other view is to say auto-enrolment is coming, so we should just embrace it and sell the positives. The communication piece on selling the positives is really important, otherwise individuals will only think of the money they are losing from their pay packet. Employers are going to have to think that through and probably be a lot more creative in the way that they look at benefits as a whole.

Unless the employee has that communication they won't understand it, but it is down to the employee to take some responsibility. It is increasingly a lifestyle choice that people are making: do I want to retire when I

am age 60 or am I happy working until I am 80?

Nest

Q You either put more money away or you retire later - it is that simple. But why do we not seem to have that as part of the communication around Nest?

HARRIS: It does not have a budget. Australia spent about US\$11m in 18 months getting its system ideas out. In Singapore, their CPF is bombarding people, but there is no fear in this system. The hard reality is that if you do not save for retirement, what is the penalty?

BRASINGTON: We are unique in the UK because we have something called national insurance contributions. We are already paying in and the government is going to give me a pension when I retire. That is the way most people think. The other thing is all about outcomes, in other words, what is needed to provide £100 a week. You need to save about £30,000 over the next 30 years, but people will say they cannot possibly save that much and will wonder if it is really worth doing. There is a massive job to be done on this whole re-education of saving for retirement, or the word 'pension'.

CHESELDINE: The point of government is, first, to set a safety net for people who fall through the system, but also to make sure that as few people as possible need to be caught by that safety net. Therefore, they have to design and build a structure and facilitate it so the bulk of the population never go anywhere near the safety net. That is what Nest is for. But the government is relying overly heavily on the providers to do the education. The principle was always that there would be masses of publicity around auto-enrolment, but it has not happened and there isn't a budget anymore. That is a problem. You cannot have such a step change in pension provision without engaging the public.

WATTS-LAY: The problem is also that we have spoken to companies

that have a lot of low-paid, minimum-wage-or-just-above workers who have found the big providers are just not interested. Therefore, you cannot even rely on the providers at that bottom end, because they are not happy to provide a pension let alone give any education.

CLEAL: Very much like Andy, I feel there is a role for the state in providing a safety net and that is a societal question. Not all societies would take that view, but there is a very critical role for both employers and individuals to save for themselves for what is effectively income replacement, which comes back to the question about what your aspiration is for the standard of living you would like in retirement. In this country and, indeed, in others, we have not been good at communicating to people if you want to have a certain standard of living in retirement, this is how much money you ought to be saving as a percentage of your salary. We have not been very good at giving clear messages to people, partly because it is complicated and is difficult to generalise, but I think it would help.

Going back to Jonathan's point, people have a sense of the different costs of cars or houses, but it is very difficult with retirement income. In fact, some of us around this table might struggle to clearly define how much we should be saving to meet a given standard of living. There is a disconnect between something that is very far in the future and action that needs to be taken today, so I think the communication piece is essential. That is not just because of auto-enrolment or Nest, but across the board if you want people to save for themselves - and I think the demographics mean they have to save for themselves, the government is not going to be able to afford to do it for them - we need to get much better at communication.

CHESELDINE: We have to recognise that funding retirement does not just come from savings and producing an income alone;



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it comes from an absence of expenditure. Therefore, those people who buy their own house then do not have to rent and that is a very substantial chunk of income they do not have to find out of net income. If they pay off their debt before they retire, that again, for most people, is quite a substantial section of their income. If people are paying, for instance, 10% to an ISA or pension during their working life, come retirement they do not have to find that 10%. Currently, national insurance does not apply to pension income or investment income and that again is a benefit. When you put all those factors into the equation, most people are not quite as badly off as they might think they are, but it is just immensely complicated to get the message over.

MINGLE: At the lower end you are absolutely right, you might only need a 60% replacement ratio from a company scheme. However, for people on £15,000 or £20,000 a year – which is where the bulk of the problem lies – that’s still much more than they are projected to get under existing Nest contributions. Of course, one of the problems the bulk of companies with DC schemes have with communication is that the message is not very palatable. On the one hand, they want to say, ‘We have this great scheme; it provides you with super benefits, join up.’ But you do the projections, convert the projected fund to an annuity and it is nowhere near what folks are expecting or need to receive. That is a hard message to give people.

CLEAL: Of course the Nest minimum levels of contributions are not going to be enough to even get a median earner to hit their replacement rate. It was originally envisaged that you would have a combined contribution of 8%, but the individuals themselves and/or their employers would need to put in an additional 8% to hit the two-thirds replacement rate. So I think there is a real set of issues about making sure that message is communicated. Simply doing the minimum default 8% contributions is not enough. That is meant to be very much a minimum starting point.

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A holistic view

Q How do we get people to take a more holistic, rounded view of benefits in the workplace?

WATTS-LAY: This issue has arisen because of longevity. People are healthier hence they are living longer, so doesn’t there need to be a complete rethink of why people think they have a right to have a retirement income for 25 or 30 years? I know in some ways that is quite a complex thing to get across to people and again it probably needs government input in terms of communication, but it is hard because you have unions, for example, that get their subscriptions from members who tend to say they want to retire at 60 because people have always retired at 60.

CLEAL: That does come back to education, though, doesn’t it? I agree we do need a complete rethinking of retirement and the whole idea that retirement is something that happens at a particular age – whatever that age is – is out of date. However, that is not where public opinion is and it is very interesting that it took an independent commission in the form of the Pensions Commission to even be able to raise the prospect of increasing the state pension age. Prior to that, no politician would touch that issue. We had had 50 years where the state pension age should have

increased when no politician would touch it.

There is a huge exercise to engage young people and to explain to them in an easy-to-understand way what these demographic trends mean. To be fair, the government is starting to do more on that now we see the debate about state pension ages and where that might go. We have had the abolition of the default retirement age. All of those changes are sending a message that you can no longer assume you are going to retire at 65, which is good, but it is only a very small starting point. It is a step in the right direction.

MINGLE: The message is nowhere near stark enough and, as you say, this is driven by fear and a political reluctance to go further and tell it as it really is. There needs to be such a big shift in mentality about retirement ages and, at the moment, we are going to have people realising they cannot afford to retire at 65 only when they reach 65. To get the message across the communication has to be more intensive and frequent. Frankly, it has to start in schools with the financial basics, because of the level of ignorance of the average employee is often staggering.

WATTS-LAY: There is also short-term savings to consider as well. For a lot of young people benefits like the workplace ISA, share schemes, save-as-you-earn schemes, and so on would prove highly beneficial.

HARRIS: What is happening around the world is a move away from the word 'pension'. When I go to Australia people talk about 'my super' and the new word 'super' has a powerful connotation. If you go out to the Midwest, they talk of 'my 401k' even though they don't realise more generally that it is a retirement vehicle. It is developing great levels of ownership.

BRASINGTON: If when the Tories came in they had said on day one, 'national insurance contributions are halved, you will no longer receive a state pension, it is up to you,' how would that have changed the world? People very much would say, 'It is up to me. They are going to give me nothing,' so the whole marketing of these things, all the advice on these things, kids going through school would have known. I am not saying we should have done it – or am I? – but it would have been interesting to say, 'This is now down to you.'

Role of the employer

Q People generally do not trust governments or banks and financial institutions, but they do trust their employer, because it pays them each month. So how do we incorporate that into the workplace?

CHESELDINE: Personally, I believe in the separation of those. If you just look at the numbers around pensions and ISAs, in very rough terms £14bn or £15bn went into DC pensions last year – £24bn or £25bn if you include individual, self-employed, etc – and £45bn went into ISAs without any matching from the employer. You just said that people do not trust financial institutions, but they do trust an employer, but they put three times as much into ISAs as they did into pensions. That is because they think at least it is simple.

MINGLE: Also, they do not trust pensions.

BRASINGTON: It is flexible as well. If they reach age 55 and have to pack up work, they can still get their money.

MINGLE: My experience is that employers' mentality is increas-

ingly about whether they receive value for money for the benefits they provide. That can be very difficult to quantify. In order to get that employee appreciation of a pension scheme, they have to work very hard at communication; other savings and reward vehicles are more self-evidently a good deal. It may be, thinking holistically, that one of the trends we will see is long-term saving becoming an accumulation of short terms, where people go into different, relatively short-term saving vehicles and roll them over, while still having the flexibility to take the money out should they really need it. That way, they are still ultimately able to develop a reasonable pot at retirement without having to have their funds locked away from day one.

HARRIS: It is interesting with the FTSE 350 companies' share save programmes; they have enormously high levels of participation yet within pensions they do not have the same experience. It really comes down to whether a government rewards people who show thrift and penalises people who consume more.

CLEAL: There is an important principle that when you are saving for the long term you want diversification of risk. As an individual, I am not convinced necessarily that having a lot of your eggs bound up in the prospect of your employer basket is necessarily a good thing. If your salary is paid by that employer, there are good reasons why a pension is a good vehicle for diversifying individuals' risks and yet we do not seem very good at communicating that. I worry slightly about share-save-type schemes as they lead to a lack of diversification and we have to be quite careful, because in some ways they are quite easy for people to latch on to and understand, but I do not necessarily think they offer a good long-term solution as the entire answer for people's savings for retirement.

WATTS-LAY: I tend to agree. If you look at a save-as-you-earn scheme, once it has reached maturity people need to diversify. Whether it is in a pension or an ISA or anywhere else, they do need to diversify. You only have to look at Enron or HBOS

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to see people who have lost almost every penny they had in the shares, plus their job, so financially it can't be very much worse in one fell swoop. However, I do think save-as-you-earn schemes are good because at the end of the day it is just cash savings, and you either take the option or not when you know if you are in the money.

However, even simple things like this employees do not understand. They do not understand this scheme is just cash. You get your money back with interest if it is under the strike price, but if it is above the strike price you can just take the share and cash it in straight away. In fact, we even say the best place to use a workplace ISA can be maturing save-as-you-earn schemes, even if you want the money. And there is going to be a taxable gain on it as you can use your workplace ISA to mitigate the tax, even though you are going to sell it all the next day to buy a car. That is a fantastic benefit for the employer to offer.

Decumulation

Q When do we start telling people about what they need to do to take the money out? Some people have suggested it should be phased, but that alone is a complex term for people.

WATTS-LAY: Flexible retirement requires people to understand their options and the vast majority of employees do not understand what those are. It always worries me that we have talked a lot about people not saving into a pension, but for those who have saved into a pension for 30 or 40 years, they are almost abandoned at the point it really matters. To me that is madness.

HARRIS: The employer retreats and the regulation does not really look after them and then they are exposed to advisers who, in some cases, are remunerated quite highly. If you think about the regulatory costs we pour into the accumulation phase of somebody's push towards retirement, enormous amounts go in, but in the disbursement phase it is relatively small, which I find unusual.



We are going to encounter more flexible annuity structures. In the US, and certainly in Australia and Asia, the baby-boomers are displaying very unusual behaviours. They have done very well out of property, inheritance, and on the stock market. It is going to be increasingly difficult for that set to accept putting all their money into an annuity and going to Florida or Bournemouth and just hanging out peacefully. They will still want to engage with the market and so in the US they are trying to build such structures. I do think the financial engineering at the moment is trying to give these baby-boomers the flexibility to dabble, still engage, but also giving some mortality risk when they pass 70.

CHESELDINE: It is difficult to see how in the UK we could offer more flexibility than we currently do. You do not have to buy an annuity; you can go for drawdown. If you do buy an annuity, you can buy a term annuity and invest the rest. You can buy unlinked annuities, with-profit annuities, escalating, level – all the variations, so in fact we do not need more flexibility. What we need is a package that suits most different groups or segments and we need a communication strategy that works, that gets the high-level stuff over to people without complicating it too much, but without hiding anything. That is the difficult bit. I will leave that to the providers.

CLEAL: We did some research on this, looking explicitly at what might be the impact of the government's decision to end the requirement to annuitise before age 75. We discovered only about 600,000-700,000 people might be able to take up capped drawdown in 2010, assuming a pot of about £100,000. That is about 5% of those in the 55-75 age group, so it is quite a small proportion. Then we looked at how many might meet the government's new minimum income requirement and have total freedom and total flexibility to withdraw what they want. The figures were even smaller: we went down to 200,000 that could meet a minimum income requirement of £20,000 a year, which is about 2%

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of people in that 55-75 age group in 2010.

Although on the face of it there is a lot of flexibility. The vast majority of people are not going to be able to take advantage of the flexibility unless the drawdown market changes very substantially or we reach a point where drawdown becomes more economic for people with smaller pension pots. We are not there yet.

The Sunday papers may be telling people they no longer need to buy an annuity, but in reality for many people best advice will be to do exactly that. There is a dichotomy there.

Post auto-enrolment, those numbers will change and they will build up, but in the here and now I do not think so many people are going to be able to use the full flexibilities.

Future directions

Q Where do you hope the trajectory may take us in the next couple of years?

MINGLE: I hope I am not being too pessimistic, but it just seems inevitable that we will end up with compulsion. I do not have faith that anything else is going to be able to deliver a scenario where people have sufficient savings – of any means, not just pension – in order to be able to finance a reasonable lifestyle in retirement. Yes, there are associated headaches and potential anomalies and inconsistencies,

and all the reasons it has not been introduced in the past, but it's not as if what we are trying to do now is without its headaches either. Ultimately I just see it as inevitable.

WATTS-LAY: There are two things I think we need to push for in the next two years. The first one is retirement income, which is about lifestyle, and that means different things to different people. But that is why there needs to be good financial education, because people need to understand the parameters in which they can save. That may not necessarily be a pension in the workplace, it can be other things, whether they are ISAs or save-as-you-earn schemes or whatever. Therefore, we should stop using the word 'pension'. The same way as you think about lifestyle income when you are 25 or 30, in terms of what car you want to drive or what flat you want to live in, you should also think about those lifestyle options when it comes to retirement.

The second thing is the industry, and possibly government through regulation, really needs to up the game in terms of making sure people understand what their options are when they reach retirement. It is near on a disgrace that someone can save for 40 years and potentially make a random decision after that length of time of saving when they go to generate retirement income.

HARRIS: We are going to see the continual integration of financial services into the online world.

The take-up of Facebook, Twitter, and others are suggesting that the younger generation has to be somehow engaged. Therefore, you are going to see in the next few years Nest, government agencies and financial service providers increasingly going down this path. Already we see financial services providers investing £150m, we calculate, in these corporate platform solutions. It is either going to work very well or not work at all, but it is a big bet.

The challenge we have to work on now is how to make Nest sensible in terms of working with the existing infrastructure. Is there going to be a multiplicity of individual accounts and is there going to be a multiplicity of individual administrative costs and considerations? When we get to the review stage of Nest and retirement in the future, are we going to reach a point where we allow accounts to be merged and are we going to get to a point of compulsion?

CHESELDINE: Governments will do what they have to do to survive. Regulators, no matter what we say, will just confuse matters. The government is now saying it is going to introduce legislation to tell us that DC pensions are defined benefit (DB) if you offer a guaranteed investment return. Great. That is really not helpful. Financial services providers and advisers will build products and services that fit in the overall con-

text and they will be driven by profit motive mostly, so what they build should be effective within the constraints of what they can aim at.

However, what the public needs is financial education at the broadest possible level. The OECD publishes data on how much net income we all have. They do it in US dollar terms by what they call 'purchasing power parity' and consistently for the past 10 years the UK has been near the top of that list, third or fourth most of that time. It is ahead of the US, France, Germany and most of the other countries in Europe. Does the public understand that for all we say 'we cannot afford to pay money for pensions, we must have all this debt' we are probably better off than 99.9% of the rest of the world population? So let's get real about what you can afford.

We are told longevity is increasing by broadly one year in six, and that is probably an underestimate. On that basis – and slightly tongue in cheek – if we consider the historical data of old veterans marrying younger women and look at the guys fighting a war in Afghanistan at the moment, then assuming they come back in one piece, we could be paying benefits to their widows in 2174. That is just one reason why employers cannot afford to maintain DB.

We need to understand that people live a very long time and in a more realistic scenario, you cannot afford to have 25 or 30 years of

I really fear there will be a missed generation of people falling way short on what they need

pension based on 35 years of work.

BRASINGTON: I applaud the work that has been done on workplace platforms. I think they are really, really important. Education at school is vital for people following that missed generation. They need to be taught at school simple financial planning and what it is all about.

Whatever the product, we must demonstrate outcomes. Unless we can demonstrate what people can expect to achieve, the younger generation will not engage with it at all.

The Financial Services Authority has to understand that cheap is not always good. They are obsessed with low fees within funds, within wealth management companies as the way to go, and I have seen it written in some reports. It is not. Sometimes, if you want value you have to pay for it.

CLEAL: I would like to see more financial education. School is the obvious place to start with that, but I do not think that education is in and of itself enough. I do not think if that was all you did we would get the kind of sea change in behaviour we need. You have to work with people's inherent instincts and behaviour, and that is why I am a strong supporter of auto-enrolment and I am an optimist when it comes to auto-enrolment. There are two things that will drive the success of those reforms. One is what individuals do in response – do they opt out or do they stay in? A lot more work needs to be done to try to encourage people not to opt out and to explain to them what the benefit is of saving in a pension and why this is something that is worthwhile.

Finally, more broadly, I would like to see some changed attitudes to retirement. We need to get away from the notion that you retire at a fixed age. We need to think more flexibly about patterns of work near retirement, so more part-time work and probably more contract work. We need to get away from the idea that retirement is something that happens on your 65th birthday; you work full-time on Tuesday and then you stop working entirely on Wednesday. ■

