For employee benefit consultants and employers only

Countering the cost-of-retirement challenge

Live long and prosper

‘For many people, being asked to solve their own retirement savings problem is like being asked to build their own cars.’
Richard Thaler, Nobel Prize Winner in Economic Sciences

An inconvenient truth is currently exercising the best minds in the pensions industry: the established model for providing adequate income in retirement, for members of many major Defined Contribution workplace pension schemes, is failing and is in urgent need of repair or replacement.

Members of many such schemes are at risk of either falling into retirement poverty, or simply being unable to afford to retire. This widespread predicament undermines the core purpose of workplace pensions which is to allow employees to live their later years with dignity.

The reasons for this problem are many. In the current economic climate, a cost-of-living crisis – aggravated by macro-economic changes, structural societal shifts in employment conditions, generational wealth divides, age demographics, and increased longevity – is translating into a cost of retirement challenge.

In this paper we discuss the various causes and effects of this cost-of-retirement challenge before evaluating potentially effective responses. We posit solutions that may effectively ensure that the trinity of investment risk, inflation risk and longevity risk is shared between employer and employee with neither party having to bear the entire burden. The objective is to ensure that current affordability and later life income adequacy are balanced so that members receive a liveable retirement income for life.

The iniquities of income inadequacy

Several powerful socio-economic factors have contributed to the current retirement income challenge and various strategies offer the potential means to address it. These include raising minimum auto-enrolment contributions or encouraging the payment of voluntary contributions, for example, with more employers introducing pound-for-pound matching of employee contributions. A new generation of tailored member engagement tools providing information, guidance and advice would support this.

A second strand of inquiry focuses on innovative and alternative decumulation strategies: these include enhanced drawdown strategies; revamped annuities; tailored glidepath designs in the run-up to retirement; and hybrid collective defined contribution (CDC) decumulation models.

In tandem with these policy- and communication-based responses, there is increasing openness to rethinking attitudes to retirement itself. This manifests in the increasing advocacy of, and demand for, flexible and potentially reduced hours working past the 'traditional' age of retirement. Such flexible working is becoming both more feasible and more desirable.

The number of people aged 65 and over who are in employment reached record levels in 2022. A trend towards so-called 'unretirement' is now emerging, with one in four retirees in the UK returning to work, mostly within five years of retiring, driven in large part by financial necessity.[1] Corroborating this concerning trend is the fact that one in three individuals now expect to work to the age of 70 or beyond, while one in four people believe that they may never be able to afford to retire.[2]

At the same time, however, government figures indicate that the number of over-50s becoming economically inactive has surged significantly in the last two years.[3]

These factors suggest a climate in which workplace pension scheme members are not able to contribute as much to their schemes as they would wish, due to financial pressures and income volatility. Indeed, one in five pension schemes surveyed by the PLSA have seen savers asking about reducing or stopping their pension contributions, with a fifth wanting early access to their pension after age 55.[4]

Mind the gap: what is enough?

In any meaningful discussion of strategies for ensuring adequacy of retirement, or later life, income, it is first necessary to find some consensus on the thorny and highly subjective issue of what constitutes adequate income. Several reputable organisations have sought to offer precise and standardised definitions. They include the Pensions Commission's target replacement rates, first proposed in 2004, the Pensions and Lifetime Savings Association's (PLSA) retirement living standards, and the Joseph Rowntree Foundation's standards of retirement income.

The Pensions Commission proposes a replacement rate for retirement income that is a proportion of earnings in working life. It recommends a rate of 80% for low earners, dropping to 50% for higher earners.[5]

On that basis, there is a continuing gap between the default level of automatically enrolled contributions and the level required to achieve the Pensions Commission's definition of adequacy. At current saving rates, only around half (49%) of households are projected to meet the Target Replacement Rate (TRR) as prescribed by the Pensions Commission.[6]

The TRR takes account of state pension income as well as income from workplace and private pension schemes.

Meanwhile, one in four people over 50 are currently at risk of not reaching even the minimum standard of retirement income set out by the PLSA.[7]

After a decade of auto-enrolment, participation in workplace pensions has increased from 55% of those eligible in 2012, to nearly 90% today.[8] However, of the 20 million people saving into a workplace pension, the vast majority aren't saving enough. As the cost-of-living crisis intensifies, the prospect of successfully nudging people towards the often recommended 12% savings rate, without a legal requirement to do so, looks increasingly remote in the current financial climate.

Major employers have spent the last decade focused on ensuring that employees have some retirement provision. Based on the evidence of current income levels, the challenge for employers now is to ensure that the provision is adequate.

49% of households are projected to meet the Target Replacement Rate

Lateral thinking on later life

The headache for major employers is how to square the circle of workplace pension provision. On the one hand, they want to provide employees with a meaningful pot that gives an adequate, sustainable income in retirement with reduced drawdown risks. At the same time, they want to fix their own costs at a manageable level.

Income inadequacy can be addressed in four fundamental ways: put more money in; achieve better investment returns; work longer; or take less money out. In other words, by requiring workplace DC pension scheme members to defer their retirements or to substantially increase their voluntary contributions. The question that arises is whether this is sufficient to allow employees to live with dignity, security and comfort in later life.

Certainly, major employers can start by adjusting the focus of their lens on their over-50 cohort of employees by implementing strategies to retain, retrain and reskill experienced and motivated older workers. These will include a combination of flexible conditions, carer leave, and lifelong learning.

By embracing the reality of the transition to a longer working life, major employers can support the health and wealth of a multi-generational workforce while offsetting some of the income challenges of retirement.

Several other factors can contribute to improving the prospects of major scheme members having adequate later life income. They are explored in the following pages.

Facilitate increased contributions

The payment of more voluntary contributions by members has not materialised to bridge the gap between statutory minimum auto-enrolment contributions and adequate retirement income. Especially now, in the aftermath of the pandemic, with soaring inflation reaching forty-year highs and a cost-of-living crisis that saw three-quarters of UK adults trying to cut back on their spending[9], there is little scope for scheme members to make those additional contributions to top up their pots.

However, paying more money into pension pots is a logical starting point for increasing later life income. Introducing timetables to increase current default auto-enrolment contribution rates as well as the auto-escalation of both employee and employer contributions, has the potential to help remedy the deficit in savings.

This could follow the model adopted by emulating the gradual contribution rises in the Australian Superannuation system. Under Australia's Superannuation Guarantee Laws, employers are currently required to pay the equivalent of 10.5% of ordinary time earnings into their workplace schemes.

Since the Australian government is concerned that this may still be insufficient to provide adequate later life income for members, there is a ratchet in place to gradually increase contributions by 0.5% every year to 12% by 2025.[10]

The so-called general super guarantee began in 2020 when contribution rates were 9.5%. Australia considers that 12% contributions are necessary to provide comfortable, independent income on retirement. This compares with the current 3% employer contribution in the UK, with staff contribution of 5% (although this has increased from the 2% minimum contribution at the launch of auto-enrolment in 2012).[11]

However, UK employers have the option to pay in more than the legal minimum to their workplace pension schemes.

Theoretically, other than the Annual Allowance on total contributions (recently increased for most people to £60,000), there is no maximum limit to employer contributions which are eligible for tax relief. According to the Office of National Statistics, some 15% of employers already contribute at least 8% of salary to their employees DC scheme.[12]

Agreeing to match employee contributions to a higher level could stimulate employees to contribute more to their pensions. According to Aon, the average default pension contribution from employers in 2021 was 6% and at 4% for employees[13]. While this reveals that some employers are prepared to pay in more than the minimum statutory requirement, it is still not sufficient.

12% contributions are expected to provide a comfortable retirement in Australia

Optimise charges

Charges play a significant but underappreciated role in determining the size of pension pot available for retirement and later life income. Selecting providers with optimal charges can contribute substantially to the value of an individual's retirement savings.

Ireland's Pensions Authority has calculated the impact of charges on funds, in the case of a member making contributions of €300 per month over a 20-year period, with an allowance for investment returns of 6% per annum. In such a case, a 1% annual management charge would reduce the value of the fund by over 10%.[14]

This effect can also be seen in the example of a scheme member making regular contributions of £100 per month for a period of 30 years. Assuming 5% annual growth and no contribution escalation, the ultimate pot size of a fund with a 0.5% charge is £74,981 whereas the final size of a pot subject to a 0.75% charge is £71,788. That is a difference of £3,193, or 4.4%, over the period.

On average, pension scheme members were found to be paying over five times more than necessary in pensions charges.[15] In this scenario, the more transparent and competitive master trusts have a key advantage in achieving income adequacy in retirement and later life. The average UK Master Trust charges around 0.3%-0.4%, well below the 0.75% cap imposed by regulation.

Review strategies

Auto-enrolment has made both joining and contributing to a pension scheme an automatic process in DC workplace pensions. Unfortunately, the same cannot be said for the decumulation phase. Currently, this relies on people who are often neither financially astute nor able to afford a financial adviser to manage their own drawdown. This does not work for most people. Indeed, research indicates that four in five retirees in the UK do not seek advice on their retirement planning.[16]

What the majority want, however, is a decumulation product not a process. Annuities serve this function to an extent, but innovation is taking place to create, and make available, similar mechanistic products for the many who have no knowledge of, access to, or interest in, wealth management. It appears that there is scope to create more effective default decumulation products.

Many workplace schemes are target-date or lifestyle funds which automatically de-risk the asset allocation in the members' funds – less in equities, more in government and corporate bonds – in the final years before the agreed retirement date. These approaches need to adapt. For those intending to use flexible drawdown, alternatives are needed to default strategies that build up substantial holdings of cash for members as they approach retirement since they are at risk from inflation.

The generic accumulation products that are widely used today for individual flexible drawdown – such as total return-focused smoothed funds and risk-rated multi-asset funds – are quite basic. Their aim is simply to remove the impact of short-term volatility, stock market fluctuations and sequencing risk. They work on the basis of cancelling 4% or 5% of units a year to generate income. Unfortunately, the reality is that half of all drawdown withdrawals are made at a rate of more than 8%, double the sustainable level identified by Fidelity International.[17] While this figure may be distorted by those with very small pension pots making substantial withdrawals, it nevertheless gives rise to concern.

8% half of all drawdown withdrawals are double the sustainable level

However, in the context of income adequacy in later life, innovative and creative alternative products and ideas may come to the fore. They take a fresh approach to the relationship between accumulation and decumulation phases, moving from total-return focus to a balance between total return and natural income (see Innovation in retirement products overleaf).

Innovation in retirement products

To-and-through funds

Target date funds are the most widely used default investment alternative. In these a "to" glide path is designed for members who expect to invest in the funds up until retirement, while a "through" glide path is for members wishing to withdraw funds gradually after retirement. Now that distinction is being eroded by so-called "To-and-through funds" that cover both the accumulation and decumulation phase, flexing for active retirement from the age of 55 onwards, and mature retirement from age 75 with the corresponding focuses on drawdown and capital preservation.

Bucketing

Pioneered in the US in the 1980s, the bucket strategy is designed to balance income stability with capital growth in retirement. The aim is to ensure that retirement savings last while allowing the withdrawal of funds for living expenses. This is a multi-pot strategy with each pot, or bucket, being invested according to when the member will need the income.

In the bucket strategy, the retirement fund is allocated to three buckets with different time horizons: a short-term, liquid cash bucket; a medium-term defensive bucket, invested in assets such as fixed income and bonds; and a long-term equity bucket with a more aggressive growth emphasis. Over time income generated in the moderate and growth buckets is paid into the cash bucket to keep it topped up.

This strategy has attractions but clearly requires a reasonable real return on the cash component, a caveat in a high inflation environment.

Drawdown and guaranteed income

A lack of appetite for traditional annuities is giving rise to interest in hybrid or third way products that combine a guaranteed base income in later life with flexible withdrawals. Such products seek to combine rising income and flexible access to pension pots with limitations on downside investment risk. As a half-way house, though, the guaranteed portion of income is likely to be lower than with either conventional drawdown or lifetime annuity.

Deferred annuity

A popular option in the US, the deferred annuity is a variant of the bucketing strategy, which pays out later in life. Effectively, members would set aside some of their pension pot at retirement, allowing it to grow in a deferred

annuity, while taking the rest of their pot into their flexible drawdown fund.

The deferred annuity would kick in when the drawdown fund was eventually depleted, providing a guaranteed adequate income in later life and offsetting longevity risk. As a function of being deferred, the annuity pot can be invested appropriately in growth assets for longer.

Pooled annuity fund

A different hybrid take on the drawdown and guaranteed income product, pooled annuity funds are designed to collectivise and almost eliminate longevity risk. All participants become the beneficiaries of each other. So-called longevity credits, the funds of newly deceased pool members, are regularly redistributed to surviving members.

This reduces the risk of running out of money in retirement/later life and opens the way to pursuing growth investment strategies for higher life-long income, since there is no requirement to guarantee that income. The pooled annuity could be a closed fund with a single cohort of participants or an open fund with regular intakes of new cohorts every year to ensure sustainability. Australia's group self-annuitisation products (GSA) is one such real-world example.

In-retirement CDC

This strategy is based on the ethos of the collective defined contribution (CDC) scheme but applies it only at the decumulation stage.

The Department for Work and Pensions (DWP) has stated that decumulation-only CDC, offered though trust-based workplace pension schemes, could help improve member outcomes as an attractive alternative to drawdown. While this strategy is not yet permitted in the UK, the DWP is currently consulting on the possibility of expanding the Pensions Schemes Act 2021 to allow for multi-employer CDC and decumulation-only CDC.

Again, the rationale is that such products would allow members to share investment and longevity risk while also permitting them to invest in higher return-seeking assets for longer so that their pension savings work harder for them.

Adoption of decumulation-only CDC schemes represents an opportunity to return to a form of collectivist provision, with potentially more predictable outcomes for members, after decades of individualised defined contribution provision.

Crucially, though, from the employer's perspective, members share risks with each other, but not their employer. While it is not a panacea, and may not suit everyone, CDC has the potential to address several issues including the cost involved in the retirement transition from accumulation to decumulation, small pot sizes, and poor education around choice and longevity risk.

Improve information, guidance, and advice

Since most DC scheme members are no longer purchasing annuities to secure a guaranteed income in retirement, the risks of running out of money are increasing, whether through unsustainable withdrawal rates, or because cash investments are being eroded by inflation.

In this climate people need help to understand the difficult choices facing them. This should focus on effective and accessible guidance on contribution rates and retirement options. The UK currently has no clear adequacy objective for pensions and retirement income, nor any ongoing monitoring and measuring against this.

As a starting point, some major employers are incorporating the PLSA's retirement living standards into their pensions communications along with that organisation's Guided Retirement Income Choices (GRIC) framework.[18] This is designed to guide and inform savers to optimised personal solutions based on behavioural economics, underpinned by key governance minimum standards.

These show broadly how much income is required for minimum, moderate and comfortable retirements. They are not personalised and, in practice, an individual's perceptions of minimum or comfortable will depend on their pre-retirement

lifestyle. Additional guidance, support and modelling tools may be required to ensure they are appropriate to the circumstances faced by affected savers. Members need considerable support for the difficult decisions around how much they should save or when they should access savings.

The anticipated launch of Pensions Dashboards, now expected at some point in 2025, alongside the Pension Attention campaign and Simple Annual Benefit Statements are positive developments in raising awareness and making it easier for members to access pension information.

However, more focus is needed on tailored guidance, by employee benefit consultants (EBCs) as well as providers, to encourage members to boost their contributions. Wake-up packs, online seminars, mid-life MoTs, simplified statements, and interactive portals can also play an important role in improving retirement outcomes.

This will require clarity on individuals' savings targets and clear guidance on how to address any gaps caused by shortfalls. Currently, millions of scheme members do not make any voluntary saving beyond the statutory minimum with many convinced that default rate is the recommended savings rate.[19]

Profile membership

How savers make decisions and why they make them is important, as this should influence the design and implementation of the scheme. Trustees need to ensure they understand their savers' characteristics, such as: age profile, saver type, pot size, socio-economic demographic. They also need reliable information on how and when savers are accessing (or planning to access) their benefits. Accurate information and member insights, based on behavioural economics, could lead to better scheme design and member outcomes.

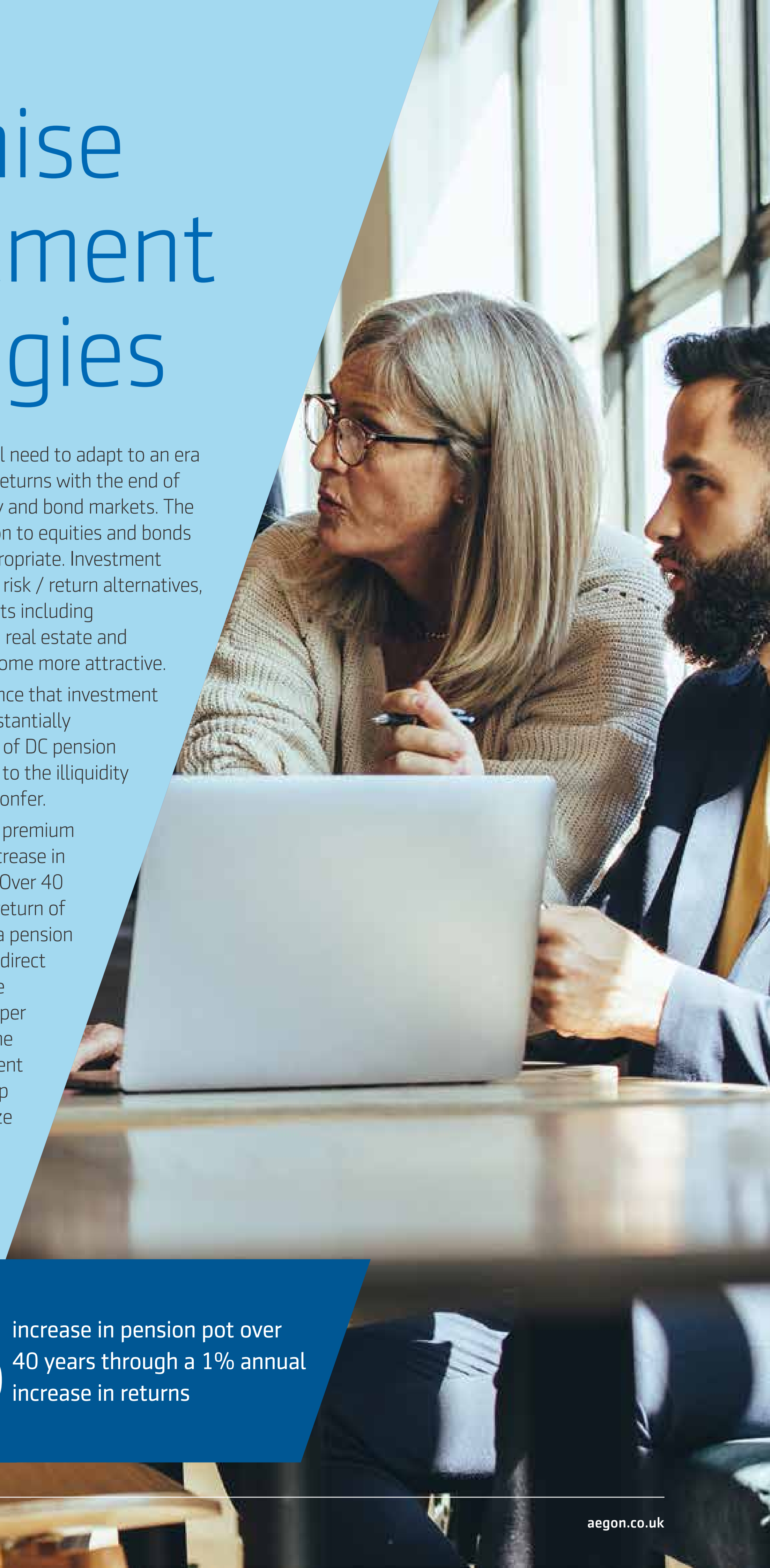
Empathising with members' hopes and fears while understanding and responding to their needs is a fundamental aspect of the new governance. Knowing your customer base requires the use of profiling and segmentation tools, focus groups and targeted member surveys.

Optimise investment strategies

Investment management will need to adapt to an era of potentially lower market returns with the end of the 40-year bull run in equity and bond markets. The classic 60/40 asset allocation to equities and bonds respectively is no longer appropriate. Investment solutions based on potential risk / return alternatives, such as private markets assets including infrastructure, private equity, real estate and private credit look set to become more attractive.

Indeed, there is strong evidence that investment in private markets could substantially improve returns to members of DC pension schemes, by allowing access to the illiquidity premiums that such assets confer.

Calculations of the illiquidity premium range from a 1% to a 7% increase in return over the long-term.[20] Over 40 years, an increase in annual return of 1% can increase the size of a pension pot by 49%.[21] Returns from direct infrastructure investment are cautiously forecast at 4-8% per year (net of fees). This has the potential to improve retirement outcomes for DC savers by up to 20% depending on the size of the allocation.[22]



49% increase in pension pot over 40 years through a 1% annual increase in returns

Conclusion: customised for major employers – master trust steps up

The challenges of providing adequate later life income are affected by several factors, including greater longevity, imbalances in generational wealth, inflation, and changing employment patterns.

While there is no single, silver-bullet solution, the issue can be addressed effectively through an optimised combination of the following approaches:

- Facilitating increased contributions (including matched contributions)
- Enhancing member communication and engagement
- Adapting investment strategies to maximise returns by exploiting the illiquidity premium
- Optimising charges to achieve value for money
- Innovating in decumulation products and drawdown options
- Changing attitudes to, and opportunities for, employment in later life

There is a clear need to persuade financially constrained, technically unsophisticated members to contribute more into their workplace pension by building better understanding, trust, engagement and decision-making. Those major employers who do not already do so should consider matching employee contributions to a higher level.

The necessary engagement is likely to be best achieved by providing clearer, more helpful and more effective communication and support to members. Such communications should fulfil the criteria of being proactive, understandable, focused, accessible and relevant.

The major players in the consolidated master trust sector have sufficient scale, time and resource to address this major issue in future. Their robust governance structures also give them sufficient scale, time and resource to provide some of the innovative blended and flexible decumulation products that will help to alleviate the later life income adequacy challenge.

Larger DC schemes and master trusts bring economies of scale that potentially make expert advice and in-house expertise more affordable. Their competitiveness on fees, could serve to minimise the risk of erosion of long-term pension pots caused by higher and more opaque charging structures. This offers the possibility of delivering value for money and better outcomes (in the form of higher retirement pots) for members.

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Contact: Andy Dickson
Master Trust Strategic Development Director
Aegon Workplace Investing
andy.dickson@aegon.co.uk
07919 948876

Andy is Aegon Master Trust's Strategic Development Director. He is a regular contributor to the pension trade press and a presenter at leading pension and investment conferences in the UK and overseas. Andy is the former Chairman of the DC Investment Forum and a current member of the Advisory Committee. Prior to joining Aegon UK, he was Head of Market Strategy at Atlas Master Trust and Investment Director at Aberdeen Standard Investments.

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