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SINCE 2012, AUTOMATIC ENROLMENT HAS BROUGHT OVER NINE MILLION NEW SAVERS INTO PENSION SAVING. IT IS BOTH A TREMENDOUS ACHIEVEMENT AND A LONG-TERM DELIVERY CHALLENGE IN THE CONTEXT OF THE SHIFT TOWARDS DEFINED CONTRIBUTION (DC) PROVISION AND THE MORE RECENT INTRODUCTION OF THE PENSION FREEDOMS.

Much has changed during this period to support the process. Independent governance committees (IGCs) have been created to provide oversight alongside trustee bodies and there is a much greater focus across the pensions market on cost and competition. Important steps are also being made on transparency, notably in the area of investment transaction costs.

This paper sets out an investment-focused view as to how to move forward from here. Investment is the beating heart of all pension schemes, and critical to the wider economy. Without long-term returns, schemes do not have an effective way to facilitate good retirement outcomes. And without long-term finance, the economy cannot produce those returns and contribute to wider prosperity.

A significant part of what we propose supports existing best practice in investment governance, with a focus on clear member objectives both in the DC default and into retirement. This lays the foundation for effective investment delivery and assessment of that delivery by IGCs and trustees.

Looking ahead, we outline three key areas where there is scope for pension schemes and the investment industry to collaborate:

First, developing frameworks for responsible and sustainable investment.

Second, providing access to a wider range of asset classes, including illiquids.

Third, building broader member engagement and confidence in long-term investment.

Confidence is particularly important. In the aftermath of the 2008 Global Financial Crisis, the role of the financial services industry, and its wider social utility, has been significantly questioned. The investment management industry has also been subject to specific scrutiny as part of the FCA Market Study process.

The Investment Association (IA) is undertaking a number of initiatives with members to ensure that the investment process is as competitive, transparent and responsive as possible. That process is likely to be underpinned by rapid technological change, which creates the conditions both for further modernisation but also a completely different level of connection with customers.

We look forward to working in partnership with the pensions industry to ensure the UK is world-leading in retirement provision.

Chris Cummings
CEO, The Investment Association
EXECUTIVE SUMMARY

PART ONE: MAKING INVESTMENT COUNT

• Investment should have the same priority in all forms of pension, whether Defined Benefit (DB), Defined Contribution (DC) or Collective Defined Contribution (CDC).

• An emphasis on the investment process in DC scheme design, selection, governance and value assessment will facilitate better long-term member outcomes. At the heart of this are clear member objectives for the default arrangement.

• Transparency of investment costs for decision-makers in bundled workplace DC schemes should extend to separating the investment component from other costs. This will help to enhance the value assessment process for investment.

• Responsibility and sustainability in the investment process are increasingly important themes. The IA and the investment management industry are working to build on existing frameworks to support customers going forward.

PART TWO: FACILITATING EFFICIENT ASSET ALLOCATION

• In relying on diversified market returns, DC schemes are inherently no different to DB schemes (or any other institutional investors), either in their needs, or in the economic function of the capital that schemes put to work on behalf of savers.

• The question as to what are the barriers DC schemes face in relation to investing in illiquid assets has been widely asked in recent years. We conclude that a range of supply and demand side changes could facilitate a different approach to investment by DC schemes.

• Demand side behaviour could be supported by further regulatory guidance on investment design for default arrangements. There is also scope to explore whether a new fund vehicle could better facilitate access to less liquid asset classes.

PART THREE: INCREASING CONTRIBUTIONS AND ENGAGEMENT

• The risk of inadequate contributions relative to anticipated outcome is high in the current DC environment. We support automatic escalation to facilitate higher contribution rates.

• Inertia-based tools are not enough on their own. Real engagement is necessary, and could be facilitated by the further development of decision-making tools that draw on behavioural insights and harness technological innovation.

• Engagement also depends on confidence. One important element here will be clearer and consistent communication. This will require a combination of changes. Some are pension specific such as moving away from the term ‘default’. Others relate more to the nature of investment management, where the IA is undertaking a number of initiatives.
PART 1: MAKING INVESTMENT COUNT

INVESTMENT SHOULD HAVE THE SAME PRIORITY IN ALL FORMS OF PENSION, WHETHER DB, DC OR CDC. OUR PROPOSALS SUPPORT EXISTING BEST PRACTICE IN INVESTMENT GOVERNANCE, WITH A PARTICULAR EMPHASIS ON CLARITY OF MEMBER OBJECTIVES. THIS SHOULD BE ACCOMPANIED BY FULL TRANSPARENCY OF COST THROUGH THE DELIVERY CHAIN. WE ALSO LOOK AHEAD TO CHANGING PRIORITIES WITH RESPECT TO MORE RESPONSIBLE AND SUSTAINABLE INVESTMENT.

At any given moment in pension scheme development, norms in asset allocation are driven by an interaction of factors, including: market developments; cash flows and liability profiles; trends in investment thinking; and policy and regulatory drivers.

The drivers of the increasing allocation to fixed income in UK DB schemes (see Figure 1) are well known, partly reflecting maturity, partly reflecting accounting and regulatory factors. In this context, the higher overall equity exposure of cash flow positive DC schemes is to be expected.

At the same time, DC allocations are not homogeneous. Both DB and a small number of trust-based DC schemes tend to exhibit greater diversification in their portfolios, with a greater allocation to alternative asset classes, in comparison to some DC master trusts and contract-based DC plans, where default strategies are more heavily reliant on less diversified equity-bond-cash portfolios (see Figures 2 and 3).
Longer term, there is no reason why the whole DC market should not be characterised by the same degree of sophistication of discussion around the role of different asset classes and the investment process that characterises DB delivery.

It is clear that there may be structural reasons why the approach of many UK DC schemes is different to that seen internationally. Scale is an important factor, but achievable in different ways, including through large collective investment vehicles.

It is also clear that alternatives to DC are available, notably in collective models that seek to reduce individual investment risk through a different form of pooling mechanism (CDC). Our focus in this paper on traditional DC reflects the prevailing UK model, rather than a specific IA view of how the UK pensions system should evolve.

In this first part, we look particularly at investment governance and member-focused decision-making. In Part Two, we explore more specifically how DC schemes could invest in a wider range of asset classes than they are able to at the moment.

**IMPORTANCE OF INVESTMENT GOVERNANCE**

DC outcomes are determined by a combination of contribution levels, net investment return and the way the pension account is accessed in retirement. However, investment is often not a top priority in a market where scheme selection is a legislative compliance process, which may be challenging for many employers. Research has shown that investment may rank behind administrative factors in scheme selection (see Box 1).

This prioritisation is an understandable reality of the automatic enrolment market, given the involvement of many hundreds of thousands of smaller employers, who will be relying on pension schemes to ensure that investment processes deliver effectively for their employees.

It reinforces the importance of a strong focus both on investment governance and the measurement of member outcomes in DC schemes by those responsible for default strategy design, not least to inform further evidence-based policy development. While comparison between different strategies is not necessarily straightforward, we support greater data availability and accountability for delivery.

Notably, investment approaches and outcomes did not feature in the Automatic Enrolment Review of 2017. While it may have been too early still, we encourage policymakers to ensure that future reviews do consider outcomes, particularly ahead of any further reviews of the level and coverage of the DC default strategy charge cap.

**BOX 1: EMPLOYERS’ PENSION PRIORITIES**

Recent research* suggests that acting in members’ best interests is the overriding priority for scheme governance although this means different things for different people – with independent indicators of scheme quality, low charges and quality of member communications all deemed to be important in ensuring that members’ interests are well served.

While employers also see investment performance as important for members, investment strategy design and its governance do not always appear to be high up the list of factors that drive decisions by employers.

This is especially true of smaller employers. Features such as overall member cost or the efficiency of employer processing appear to be more important factors for smaller employers making scheme selection decisions.

* Pension Scheme Governance (Pensions Insight, NEST, 2018)

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1 See for example: Enabling good member outcomes in work-based pensions, TPR, 2011.
EMPHASISING MEMBER OBJECTIVES

Effective DC investment governance rests on a set of criteria that are relevant to decision-makers regardless of the nature of the scheme, whether single employer trust, master trust or contract-based. The principles are now well established. DWP\textsuperscript{2}, TPR\textsuperscript{3} and the IA\textsuperscript{4} have all previously set out views in this area with a similar starting point: the need for a clearly identified member-focused objective for any default arrangement.

This answers the question: “what are you trying to achieve for the members?” For some, this may be related specifically to an ambition to deliver in excess of inflation, preserving purchasing power. For others, it may be more general, relating to maximising return while controlling risk. Given the current dependence on the default by the overwhelming majority of DC members, this is a critical area to get right.\textsuperscript{5} For example, NEST went through a very public exercise in researching member needs, designing a member objective and setting an investment strategy.

Such a separation is already taking place in many DC schemes, but is not yet systematic across the market. The risk remains that DC investment strategy is disproportionately characterised by an approach that starts with a heavy set of constraints around cost.\textsuperscript{6}

However framed, the key point is that the objective is distinct from the investment strategy designed to deliver it. While the objective will need to be clear and understandable to all members, the investment strategy may be more complex, depending on the views of key decision-makers for a given default arrangement.

Such an approach has three advantages:

- It focuses on what the investment process needs to achieve for the member.
- It provides a way to assess value delivered.
- It can facilitate the communication process.

An emphasis on clarity of objective may also be a useful tool as the retirement income market develops further under the pension freedoms, again building on existing best practice. For example, the overall objective may be “to deliver a sustainable income in real terms”, with a specific investment strategy underpinning it.

In contrast to the savings phase, the concept of a single ‘default’ is unlikely to be appropriate for retirement income. Instead simplified product pathways may present customers with a set of choices designed to offer a straightforward way to access drawdown or guaranteed income.

Across a saver’s lifetime, the aim from an investment governance perspective would be to ensure:

- A clearly stated customer objective, whether that customer is 20 years old or 70 years old.
- An investment strategy appropriate for the delivery of that objective.
- An ongoing review process with respect to how well that objective has been achieved.

This is not necessarily straightforward in either the savings or retirement income phase. In a DC default arrangement, it has to be at cohort level rather than for individual members. Contribution rates also matter, as discussed further in Part Three.

However, with a clear member objective as a starting point, the foundation is laid for a robust delivery process.

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\textsuperscript{2} Guidance for offering a default option for DC automatic enrolment pension schemes, DWP, 2011.
\textsuperscript{3} Code of Practice 13: Governance and administration of occupational trust-based schemes providing money purchase benefits, TPR, 2016.
\textsuperscript{5} The Future Book: Unravelling workplace pensions 2017 Edition, PPI, 2017 (The proportion of members in the default strategy is 94 per cent for Group Personal Pensions and 99.7 per cent for master trusts).
ASSESSING VALUE

Cost obviously matters here, especially over long savings periods. There needs to be a highly competitive market in which costs are strongly scrutinised in the context of the value of the service delivered. Over time, this should obviate the need for charge caps and remove the associated risk of unintended consequences.

We therefore support transparency of all investment costs, including transaction costs, and have developed new mechanisms to make this information more accessible for pension schemes. We will shortly be undertaking further work to implement the findings of the FCA’s Institutional Disclosure Working Group (IDWG).

Investment performance should also be judged net of the cost of its delivery, and not simply net of the additional services that form part of a bundled pensions product – administration, communication, governance etc.

For this reason, an additional step may be necessary in the transparency process: the ability of employers and pension schemes using bundled arrangements to be able to see the cost of the investment component of a pension product.

Considering the cost of investment separately from other costs in a pension product would allow for a better assessment of ‘value for money’ of investment, as well as whether the investment budget is satisfactory within the total cost of the scheme.

As with the FCA’s new rules on transaction cost disclosure, we see such information as being primarily for scheme decision-makers and purchasers – pension providers, trustees, employers and advisers. However, pension schemes could take a view as to whether and how such granular information should be made available to scheme members in the context of their communication strategies.

INVESTING SUSTAINABLY AND RESPONSIBLY

The enhanced focus on governance will have a benefit in other areas of the investment process. One specific area where this is likely to be the case is in relation to sustainability and responsible investment.

It is increasingly recognised throughout the investment chain that there are important drivers of sustainable and responsible investment which relate both to sustainable longer term financial returns and, for some investors and savers, broader values-based considerations.

Pension schemes may in future be driven towards taking greater account of ESG-related risks and opportunities, where these can have an impact on the value of an investment portfolio over the long term.

Accordingly, DC scheme decision makers, policymakers and regulators are showing increasing interest in incorporating ESG approaches into DC investment strategies.

A greater focus by DC pension schemes on considering ESG factors material to their investments would not only help better mitigate risks and adjust returns over the long term, but could also serve to enhance member engagement and better connect people with their pensions. A range of evidence suggests that this could be borne out in practice, although from a relatively low base still:

• A Pensions Insight/NEST report found that 26% of respondents cited responsible investment as a factor in scheme selection by the employer, although responsible investment was considered less of a priority for members.
Research on wider consumer attitudes carried out by IPSOS MORI on behalf of Aviva found that 31% of respondents said it was important to them that their pension savings are invested in projects that will help build a better future.

Recent research by Ignition House confirms that UK DC scheme members share some of these attitudes, with a significant interest on their part in responsible investment issues, which increases when they discover that they actually own assets through their pension fund.

Member sentiment could also change over time as a result of generational effects with evidence suggesting that younger cohorts may be more interested in non-financial objectives. Morgan Stanley found, for example, that compared to the overall investor population, millennial investors are nearly twice as likely to invest in companies or funds that target specific social or environmental outcomes.

The IA and its members are giving much greater priority to this area. Current actions include:

- Supporting the development of standard definitions and standards for sustainability and responsible investment.
- Improving non-financial disclosures by asset managers, including in relation to non-financial outcomes.
- Engaging with the findings of the 2017 Law Commission Report on pension funds and social investment, and the latest proposals from Government in its response. The FCA has also indicated that it will consult in 2019 on changes to the IGC remit in the context of the Law Commission Report.
- Progressing the recommendations of the ‘Growing a culture of Social Impact Investing in the UK’ report.

The IA will report to HM Treasury on the progress of this work via the Asset Management Taskforce.

**BOX 2: APPROACHES TO RESPONSIBLE INVESTMENT**

A range of definitions and approaches are currently used in this area. The term ‘responsible investment’ is used alongside the broader concept of ‘sustainability’.

Examples include:

- Very targeted ‘deep green’ objectives with investment policies which screen in or out of specific holdings according to a closely defined set of environmental themes.
- Investment in specific instruments addressing environmental risk, such as green bonds.
- Integration of broader ESG screens or increased ESG scoring which look across a range of criteria for every company in the portfolio. This can be used to drive engagement with companies in order to address and mitigate risks.
- Impact investing through investment in instruments issued by certain kinds of enterprise or hybrid organisation that are explicitly focused on a specific and intentional social impact alongside financial returns.

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12 See the Aviva IGC 2018 annual report, p17, Aviva, 2018.
17 Growing a culture of social impact investing in the UK, Independent advisory group, 2017.
Member-focused governance and transparency are the foundation of good investment outcomes:

- We support the work of IGCs and the increasing emphasis on value delivery in DC schemes. Best practice in DC investment governance should extend across the market, with clarity of member objectives a core foundation.

- The investment management industry is working to deliver enhanced transparency of costs across customer markets. Consideration should be given as to whether this transparency should extend to the cost of investment in bundled workplace DC arrangements, at least for decision-making and oversight bodies.

- Regulators should consider how performance comparisons can best be facilitated. One option is to ensure that assessment of the investment performance of different cohorts of scheme members takes place within default strategies.

- As the focus on the retirement income market intensifies, the limits of default arrangements will become more apparent with savers likely to benefit from access to simplified pathways. Clarity of objective remains equally relevant as a starting point.

Such changes should help to ensure that a foundation is in place for a process that focuses on member outcomes delivered at the most competitive cost, rather than lowest cost being the starting point.

Given changes in the wider socio-economic, political and physical environment, the conversation between pension schemes and investment managers will also increasingly involve the theme of sustainable and responsible investment. The IA and its members are preparing to support pension schemes in this area.
PART 2: FACILITATING EFFICIENT ASSET ALLOCATION

IN SEEKING TO IMPLEMENT THEIR OBJECTIVES, DC SCHEMES SHOULD BE ABLE TO BUILD FULLY DIVERSIFIED PORTFOLIOS. WE EXPLORE HOW THIS CAN BE BETTER FACILITATED THROUGH CHANGES IN REGULATION, MARKET PRACTICE AND PENSION SCHEME DEMAND. THERE IS ALSO SCOPE TO EXPLORE WHETHER A NEW FUND VEHICLE COULD BETTER FACILITATE ACCESS TO LESS LIQUID ASSET CLASSES.

Investors need to be able to access asset classes that will deliver the risk/return profile they seek. Capital markets need to be able to facilitate the flow of capital in an optimal way, whether to public or private markets, liquid or illiquid assets.

In this regard, DC schemes are inherently no different to DB schemes (or any other institutional investors), either in their underlying financial needs, or in the economic function of the capital that schemes put to work on behalf of savers.

Despite this, DC schemes cannot always invest with complete freedom, including gaining exposure to illiquid assets. This is not just a concern for the pensions industry. It also has policymaker attention, given the priority of ensuring the supply of ‘patient capital’ to the UK economy.18

A number of stakeholders are exploring these issues, including the IA. Our view is that there is no silver bullet. Rather, a series of demand and supply side measures that incrementally could help to make it more straightforward for DC schemes to invest more broadly. These measures include consideration of whether the current UK fund regime best facilitates access to asset classes such as infrastructure.

SUPPLY-SIDE BARRIERS I: PERMITTED LINKS

Unit-linked life funds are the delivery vehicle of choice for DC investments and their composition is governed by the FCA’s Permitted Links rules20, which set out what unit-linked funds can invest in.

As currently framed, these rules can significantly impact the availability of investment options to DC investors. This is because many alternative asset classes are accessed via QIS21 (or similar) fund structures. However, the Permitted Links rules limit the life wrapper to holding no more than 20% of its assets in a QIS. Furthermore, the QIS itself is required to invest only in Permitted Links. This makes it harder for DC schemes investing via life wrappers to access these asset classes.

While not all DC schemes invest via life wrappers (and are therefore unaffected by the Permitted Links rules), a sizeable proportion of the market does access pooled funds via a life company platform.

SUPPLY-SIDE BARRIERS II: DC PLATFORM REQUIREMENTS FOR DAILY TRADING AND PRICING

The prevalence of daily trading and pricing for DC funds is one of the barriers to the wider use of alternative assets in DC cited frequently by market participants.

A lack of daily valuation should not be a fundamental obstacle to including a less liquid asset in a daily traded fund. The illiquid part of a portfolio can be priced using its last valuation point. It can be updated every time there is a new valuation point. For the purposes of generating a daily price on the fund it should be sufficient to use the latest valuation of the illiquid component (plus any accruals).22

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20 Conduct of business sourcebook Chapter 21, FCA, 2018
21 Qualified Investor Schemes (QIS) represent a category of authorised fund that is available only to experienced investors who meet certain qualifying conditions.
22 Key issues here are discussed in FCA DP17/1, in the context of the experience of open-ended property funds in the aftermath of the 2016 referendum on the UK’s membership of the EU.
Subject to appropriate liquidity management tools and clear investor communication, daily priced funds can certainly provide access to less liquid assets.

The bigger question is whether DC investors need access to daily liquidity in their funds. DC default investors cannot access their money until at least age 55. There is a strong investment case for them to benefit from the illiquidity premium that less-frequently traded assets may offer.

So why does the daily trading norm persist? There is no regulatory requirement that dictates DC funds must have daily trading – instead it is the result of the evolution of a DC marketplace whose initial focus was to serve individual investors in personal pension plans, and the operational systems put in place on the insurance platforms that are host to so many DC funds.

Operationally, we recognise that there are significant challenges faced by platforms in moving away from a daily traded environment, particularly where they are seeking to respond to a range of different investor behaviours in the context of multiple DC schemes and individual accounts within those schemes. Managing cashflows in this context can be a particular issue where scheme administration operates on a daily cycle.

DEMAND-SIDE BARRIERS: DC SCHEME ENGAGEMENT

Evidence suggests that an additional issue remains limited scheme demand for alternative asset classes in DC23. This appears to be a function of three factors.

First, a lower weight placed on investment offerings by employers and DC trustees—particularly in comparison to more tangible elements of the pensions value chain that impact the member experience, such as administration and communication. This can lead to an asset allocation that is heavily weighted towards more familiar, easy accessible and liquid asset classes.

Second, there are a number of challenges in relation to alternative asset classes themselves:

- The daily dealing issue discussed above.
- Concerns about liquidity in times of market stress.
- The costs of accessing these asset classes.

Third, and linked to the preceding point, DC pension schemes face a high level of policy and regulatory change that may be diverting attention and resources from investment issues. In recent years, schemes have had to address the charge cap, scheme governance reforms and adapting to the pension freedoms.

In this context, there is a risk that the signal provided by the charge cap is that value is equated with cost, and investment becomes just one consideration alongside administration, communications and other components of pension scheme delivery.

DC decision makers may therefore have very little incentive to invest in more expensive asset classes, regardless of the possible benefits.

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There is no single measure that will fundamentally change the way in which DC schemes invest. However, a range of supply side and demand side measures could lay the foundations for a different approach.

**Permitted Links**
The historic distinction between business where the investment risk is borne by an individual and business where there is an institution acting on behalf of scheme members needs to be revised for a DC world. Workplace DC is, in our view, a retail product institutionally governed. In other words, while individuals have personal accounts and can make decisions, the default arrangement has accountability to trustee boards and IGCs.

Given the protections and degree of investment governance that should sit around DC default strategies, the Permitted Links rules constitute an extra layer of protection that may be unnecessary and are preventing investment innovation for the benefit of DC investors.

Changes to the Permitted Links rules – or perhaps even their suspension for DC default strategies – would help deliver the most efficient structures for DC schemes to access private market assets.

**DC platform requirements for daily trading and pricing**
In contrast to the issues around Permitted Links, regulatory intervention is not an answer to an issue that is mainly about market practice. It is likely that platforms will respond to changes in demand from DC schemes. It is also likely that the fund market will remain diverse, and will include vehicles that are able both to operate with daily liquidity and provide access to less liquid assets.

However, there is also scope to explore the benefits of developing a specific long-term investment vehicle that can help DC schemes access less liquid assets. Such a framework has been created at EU level through the European Long-Term Investment Fund (ELTIF). This has yet to take off in a significant manner. The IA is currently exploring the extent to which there is potential for alternatives to develop and will consult stakeholders through the summer and autumn.

**Demand side behaviour**
Pension schemes will judge their individual appetite given investment strategy and member objectives. A shift towards alternative asset classes in DC schemes may come initially from larger schemes, with scale and in-house investment expertise, before spreading to the wider market.

In the interim, further regulatory guidance regarding the investment design of DC default strategies for trustees and other DC scheme decision makers may be helpful.

Such guidance could cover:

- The need to ensure sufficient diversification of the investment strategy by considering a broad set of investment opportunities. This should include alternative asset classes, but also include a broader consideration of how different financial instruments and investment styles can best be deployed as part of the investment strategy.
- Whether the liquidity of the default strategy is optimal in relation to the profile of members invested in it.

This may provide decision-makers with the confidence to create ‘best-in-class’ DC defaults within a given budget, where cost remains an overriding constraint.

Finally, the IA supports the discussion and definition of value delivered in the context of the Spring FCA policy statement (18/8) in the Asset Management Market Study. Focusing on quality of service and performance in the context of cost offers a different starting point to the value debate than that of the DC charge cap.

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24 Pension funds and illiquidity, TPR, 2018. This blog signals TPR’s intention to provide further guidance on how trustees’ investment strategy can include illiquid and long-dated asset classes.

PART 3: INCREASING ENGAGEMENT AND BUILDING CONFIDENCE

INVESTMENT PROCESSES CANNOT DELIVER IN ISOLATION. CONTRIBUTION RATES ARE CRITICAL, AND GREATER ENGAGEMENT WILL BE NECESSARY. WE LINK THIS TO WIDER ISSUES OF CONFIDENCE AND TRUST THAT CAN BE PARTLY ADDRESSED THROUGH MORE ACCESSIBLE COMMUNICATION. THERE ARE PARTICULAR ACTIONS NEEDED TO STRENGTHEN THE CLARITY OF MESSAGE AND NARRATIVE AROUND THE INVESTMENT PROCESS.

Automatic enrolment is a game-changer, succeeding so far at a scale that is at the upper end of all expectations. One of the world’s largest policy exercises based on behavioural economics has so far been highly successful in boosting participation rates, as Figure 4 shows.26

FIGURE 4: IMPACT OF AUTOMATIC ENROLMENT: PENSION PARTICIPATION FOR PRIVATE SECTOR JOBS

The next key challenge will be contribution rates. This is especially the case when comparing DB and DC pension arrangements (see Figure 5).27

FIGURE 5: COMPARISON OF DB AND DC CONTRIBUTION RATES

This low level partly reflects the impact of automatic enrolment, whereby the effect of increased coverage and initially low statutory minimum contributions is to reduce the average contribution rate. It will certainly increase both as mandatory minimum levels increase towards 8% and the DC savings culture develops further.

While contributions and returns are both important, lower contributions put greater pressure on investment returns and higher returns can only be generated by taking higher levels of risk. This may not be something that DC investors are comfortable with, particularly as they age and their ability to absorb losses and make new contributions reduces.

In a DC environment, savers cannot therefore depend upon investment to make up for an inadequate foundation of contributions – doing so would increase the risk of them falling short of their desired income in retirement.

26 What happens when employers are obliged to nudge? Automatic enrolment and pension saving in the UK, IFS, 2016.
27 Figure 5 provides the most recent national level data on contribution rates. Data for 2017 from Aon Hewitt’s 2017 DC Scheme Survey, covering a smaller sub-set of DC schemes, shows an average default contribution rate of 9%, with 3% coming from the member and 6% from the employer.
SIGNALLING AND SUPPORT ON CONTRIBUTION RATES

One of the central challenges of increasing contribution rates is messaging to individuals about how much to save in the context of uncertain returns. Some savers, particularly those with lower incomes, will not be able to save significantly above mandatory minimums. Nor will it necessarily always be appropriate to do so given access to the State Pension and other sources of wealth and assets that individuals may hold.

A combination of approaches may be needed. Behavioural economics continues to offer powerful potential tools for encouraging changes of behaviour. US experience suggests auto-escalation and employer-matching could work in nudging contribution rates upwards. This underlines the ongoing importance of employer engagement with members.

While the issue of tax incentives in long-term savings and pensions is outside the scope of this paper, there is also an important role for tax in helping to shape contribution patterns.

Behavioural tools extend well beyond inertia-based approaches, and offer ways to encourage engagement in a more innovative fashion. For example, some research suggests the use of heuristics / rules of thumb, drawing on perceived success in other areas, such as the ‘five a day’ approach to eating fruit and vegetables.

The IA supports further development of other mechanisms, including those that help savers to target their saving to a specific desired outcome. This moves DC conceptually towards DB in taking individual outcomes as a starting point, and working back to give greater guidance as to how to achieve them.

In the DC environment, this can take the form of customer-friendly modelling tools: for example, visualising a lifestyle. These tools already exist (see Box 5), but should become the norm. Messages to ‘save more’ can be more powerful in the context of more clearly defined end goals.

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BOX 4:
AUTO ESCALATION: ‘SAVE MORE TOMORROW’

The ‘Save More Tomorrow’ plan was developed by Richard Thaler and Shlomo Benartzi in the early 2000s. Since then it has been widely implemented in corporate DC pension plans in the US.

There are four elements to the plan originally proposed by Thaler and Benartzi:

1. Employees are approached about increasing their contribution rates well in advance of any scheduled pay rise.
2. If employees agree, their plan contributions are increased with their pay rise.
3. Contribution rates continue to increase with each scheduled pay rise until a pre-determined maximum contribution is reached.
4. Employees can opt out of the plan at any time, an important feature of making employees comfortable about participating in the plan.

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29 The IA’s views on tax incentives for pension saving are discussed at length in our response to the Government’s 2015 consultation on pensions tax relief, available at https://www.theinvestmentassociation.org/assets/files/consultations/2015/20150930-pensionstaxrelief.pdf
In this context, technology is likely to play an increasingly important part, providing:

- Easier communications, increasingly to mobile devices as a norm.
- The potential for mass customisation, drawing on enhanced data-driven insights
- More advanced engagement techniques, including ‘visioning’ which can help savers conceptualise the future in a far more dynamic manner than traditional paper-based or discussion-based ways.

The Pensions Dashboard is an important potential part of this new toolkit, given the importance of helping savers better access information about their overall level of pension provision.

**BOX 5: THE ASFA RETIREMENT STANDARD**

The Association of Superannuation Funds of Australia (ASFA) has developed a Retirement Standard that benchmarks the annual budget needed by individuals to fund either a comfortable or modest standard of living in retirement.

Updated on a quarterly basis to take account of inflation, it provides detailed budgets of what single and couple households need to spend in order to fund their desired lifestyle.

The Standard provides detailed budget breakdowns on specific items of expenditure, thus helping individuals move from the abstract notion of an accumulated pension account and derived income to the amount of money needed to pay for the desired lifestyle.

In this context, technology is likely to play an increasingly important part, providing:

- Easier communications, increasingly to mobile devices as a norm.
- The potential for mass customisation, drawing on enhanced data-driven insights
- More advanced engagement techniques, including ‘visioning’ which can help savers conceptualise the future in a far more dynamic manner than traditional paper-based or discussion-based ways.

The Pensions Dashboard is an important potential part of this new toolkit, given the importance of helping savers better access information about their overall level of pension provision.

**BUILDING TRUST AND CONFIDENCE**

Both the transition to DC pensions and the pension freedoms bring an element of control for individual savers. They also bring direct exposure to underlying investment markets, and increase the visibility of the investment management industry within the savings process.

This is a significant paradigm shift in long-term savings and pension provision, taking place at a difficult time from a capital market and broader economic perspective. The ongoing effects of the 2008 global financial crisis are being seen at many levels, including weaker underlying economic growth in many developed economies. Constrained wage growth reinforces the affordability issue in the context of the debate over adequate contributions.

Given this wider context, the question of trust and confidence is particularly important. While trust in financial services has consistently been less significant in determining decisions than factors such as affordability, a range of evidence points to a considerable challenge.

Trust in government to ensure policy continuity is an additional factor identified in some studies, including the FCA Retirement Outcomes Review Interim Report.

Recent research conducted by Ignition House / Just among the disengaged over-50s highlights both distrust and lack of knowledge about pensions and the role of investment managers. It shows how totemic scandals that have no connection to DC provision, notably the Maxwell scandal, can drive perceptions even two decades later. It also demonstrates once again the difference in general trust in financial services and trust expressed in one’s own pension provider.

Significantly, and encouragingly, the researchers found that engagement changed the level of trust and the nature of the conversation. A wider question is then how to connect more effectively with savers and potential savers.

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31 For example, a Social Market Foundation survey in 2014 showed that while affordability and returns were the primary issues in determining whether people save, three quarters of those polled cited confidence in banks and financial institutions. See Savings in the Balance: Managing Risk in a Post-Crisis World, SMF, 2014. More recent evidence on a lack of confidence in financial services includes the findings of the 2017 Edelman trust barometer.


33 Rebuilding Trust in Long-Term Savings, Just, 2018.
In the pensions context specifically, one area that may be particularly important going forward is how to communicate better the nature of investment and investment risk in DC schemes. Research from NEST, amongst others, points to this being a central challenge:

“People seem to see pensions as a sort of third way, offering higher returns than saving but without the risks of investing. They have quite clear concepts of both saving and investing but struggle to reconcile the two. They’re perceived as two distinct practices, serving different purposes and with different ends. Investing is seen to be a luxury, something to do with surplus income. It’s not considered a suitable use of money put aside for a better retirement. In the minds of savers, it seems like common sense that a risky investment isn’t the appropriate approach to take to build a retirement income.”

Proposed way forward

Behavioural approaches based on inertia, such as automatic escalation, have a powerful potential role in facilitating higher contribution rates. However, they are likely to be insufficient on their own. Greater engagement is necessary and inevitable for automatic enrolment and the pension freedoms to be a longer term success.

In terms of more active engagement, savers need support in understanding their likely retirement income requirements and the associated contribution rates. Innovative tools are already being developed, drawing both on advances in technology and behavioural economics. Technological change has the further potential to enhance delivery and the relationship between scheme and savers.

Specific steps on communication

This will only be effective with better communication. Work has already started with initiatives such as the ABI’s project on clarity of language in pension product communication. We support proposals to replace terms such as ‘default’ and ‘decumulation’ with more accessible language.

At the level of the investment process, the need for greater clarity and consistency of communication is a central finding from the recent FCA Asset Management Market Study. The investment management industry supports the direction of travel and is seeking effective change. This includes work on investment objectives and performance reporting alongside transparency of charges and transaction costs.

The IA also intends to conduct its own detailed research into public attitudes to the investment process, with the aim of facilitating a better communication process between industry and different kinds of saver (and non-saver). The IA will report on the progress of this work later in 2018.

None of these proposals in isolation are an answer to a set of complex challenges. However, taken together with other actions, including member-focused investment governance and greater transparency of cost, we believe that they will help to lay a firmer foundation for successful DC pension delivery.

34 Improving consumer confidence in saving for retirement, NEST, 2014.