Department for Work & Pensions

Research Summary

GOVERNMENT SOCIAL RESEARCH
Social Science in Government

Defined Ambition: Consumer perspectives

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Background

The Department for Work and Pensions (DWP), along with members of the pension industry, has explored options for greater risk sharing to address individuals' concerns over uncertainty of their retirement income and the volatility of costs for employers. Defined Ambition (DA) is a new category of pensions the DWP would like to introduce to complement existing Defined Benefit (DB) and Defined Contribution (DC) pensions that aims to provide more certainty for individuals than DC and less cost volatility for employers than DB pension schemes.

Research design

DWP commissioned research to understand consumers' views about risk sharing in pension schemes, the appetite for greater certainty in relation to pension costs and saving, and views about the proposed DA schemes. The research was wholly qualitative in nature, conducted during September and October 2013 and based on:

- 35 depth interviews with employers – reflecting a broad range in terms of size, industry sector, turnover, ownership and type of pension scheme(s) in place;
- 9 deliberative workshops with individuals – selected for age, income, whether they are currently saving, or ever saved into a pension scheme and the type of pension scheme saved into;
- 5 depth interviews with Employee Benefit Consultants (EBCs).

Key findings

The pension landscape

Private pension saving has been falling. Over time, there has been a shift from DB to DC pension schemes. Previously, individuals were able to rely on a DB pension, guaranteeing them a pension based on their final salary or career average earnings and the length of time with their employer, with employers bearing the risks of longevity, investment and inflation. In DC schemes, individuals take on more of the risk as they save in their pension, buying an income product at retirement when the insurer promises an income for life. If DC pensions become the default alternative to traditional DB schemes, future generations face a less certain pension income. The Government, along with members of the pension industry, are looking at alternative models of pension saving that do not leave either individuals or employers shouldering the entire risk of pension saving.

Awareness and attitudes towards risk and uncertainty in pension schemes and appetite for future change reducing risk for employers (DB schemes) and increasing pension outcome certainty for employees (DC schemes)

Employers were broadly aware of the advantages and disadvantages of DB and DC pension schemes, although knowledge about specific risks and uncertainties were largely dependent on the employer's own pension provision and financial knowledge.

Employers with DB schemes were aware of the financial risks of these schemes – effects of longevity, investment risks, high management and compliance costs and having a scheme deficit on their balance sheet. Employers with a DB scheme had generally made some changes, such as increasing member contributions or increasing the pension age. With an increased aversion to financial risk, most had also introduced a DC scheme for new members some time ago, or more recently for members that were being automatically enrolled. Others were either contemplating bringing in a nursery DC scheme[1] or had already done so, whereby members would move from the DC scheme to the DB scheme after a number of years' service.

Employers with only DC schemes were aware that DB schemes could be expensive but were less aware of the specific risks. They were generally not aware that contribution levels into DC schemes were less than those into DB schemes, although some did recognise this and were concerned that contribution levels into DC schemes were too low. With cost and affordability as their key priority and having seen the negative effects of DB schemes for other employers, employers with DC schemes did not consider they had the financial capacity, or desire, to incur any additional costs or risks.

EBCs also commented that traditionally DB schemes had provided over inflated pensions in terms of the pension payable to the member, providing widow's benefits and inflation-proofing. However, they also thought that people were not contributing enough to DC schemes and suggested that contributions should be at least 15-20 per cent of salary in order to provide a viable retirement income. They also thought that as both DB and DC pensions required little or no input from members, individuals had become distanced from thinking about their retirement income.

[1] New joiners initially contribute to a DC scheme and after a set period are then moved into a DB scheme.

This was reflected in the discussions with individuals who displayed very limited knowledge about their own pension scheme and the risks and uncertainties associated with DB and DC pension schemes.

Appetite for reducing risk

Employers with DB schemes had considered reducing their exposure to risk by increasing member contributions, increasing pension age and introducing DC nursery schemes. Employers with DC schemes had not generally thought about risk sharing and when prompted were generally averse to the idea, although they liked the idea of employees having greater certainty of their retirement income.

Individuals were not generally sufficiently aware of pensions to have thought about their exposure to risk, although when the uncertainty of income from DC schemes was pointed out, there was considerable enthusiasm for greater certainty of retirement income.

EBCs were generally enthusiastic about the idea of providing greater certainty of retirement income, considered there was an appetite in the pension industry for innovation and welcomed the debate arising out of the Government's consultation paper.

Appetite for DA pensions

Overall, the concept of DA was seen positively by employers, EBCs and individuals as it could help to reduce the costs of DB pensions and provide greater certainty for DC pensions.

Flexible DB

There was an appetite among DB employers to further reduce the risks associated with DB pension schemes and EBCs felt there was a need for greater flexibility and an appetite in the industry for innovative approaches to smoothing out the risks of fluctuating investment return.

In terms of DB schemes, the consultation document[2] sets out proposals to deal with three key risks: inflation, former employees and longevity.

Employers and EBCs were weakly positive about the idea of managing the **risks of inflation** through the removal of index linking or by making it discretionary, although EBCs considered this approach tended to go against the financial trend of inflation proofing. Employers also considered that the potential financial impact on the scheme was limited as it does not deal with the accrued benefits of existing and deferred scheme members. Individuals were concerned that the removal of inflation proofing would undermine the value of their pension scheme.

Managing **risks associated with former employees** through conversion of a leaver's DB scheme to a DC scheme was viewed positively by employers and EBCs, although limited in scope only because the proposal applies only to future accruals. Individuals were concerned about the potential loss of benefits accrued in the DB scheme and that employers could act in an unscrupulous way in order to reduce their pension costs.

Dealing with **longevity risks** by extending the pension scheme's pension age in line with increases in life expectancy chimed well with employers, individuals and EBCs. This was primarily because it reflected the changes that were occurring with the State Pension.

Whilst the Flexible DB ideas were appreciated, and some had potential to reduce deficits, overall they were seen as insufficient to have a significant impact on current DB schemes, as the proposals focused on future accruals rather than the historical challenges and risks. Furthermore, employers had to consider and trade off the benefits of risk reduction with the potential negative impact on employee relations.

[2] DWP (2013) Reshaping workplace pensions for future generations https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/255541/reshaping-workplace-pensions-for-future-generations.pdf

DC Plus

The concept of DC Plus and providing greater certainty through the introduction of guarantees and income building held an overall appeal.

The consultation sets out three principles for increasing certainty of retirement income from DC pension schemes: money-back guarantee; capital and investment return guarantee; and building income certainty over time.

The principle of a **money-back guarantee** was initially greeted with some enthusiasm by employers and risk-averse individuals, but on reflection suggested a poor investment. **EBCs**' thought the principle was financially worthless but might provide a psychological benefit for highly risk-averse individuals.

The principle of a **capital and investment guarantee** was seen more favourably by employers and individuals who desired a low level of risk, but again thought to reflect a poor investment; EBCs thought a guarantee would have a detrimental effect on investment returns.

The idea of **building certainty of retirement income over time** was appealing to employers, individuals and EBCs. The logic of building up certainty of retirement income would potentially enable individuals to plan more effectively for their retirement; it would inevitably reduce the overall return on the pension investment.

Employers, EBCs and individuals felt that the complexity of DC Plus would require individuals to be adequately educated, especially for the ideas relating to building certainty through buying promises or deferred annuities[3], which were otherwise quite appealing. However, EBCs noted the lack of a current market for such products.

[3] At the time of the research, purchasing an annuity, which offers an income at retirement for the rest of the individual's life, was the option taken by the majority of DC pension holders. From April 2015, from aged 55, DC pension pot holders will be able to withdraw their pension to suit their needs, subject to their rate of income tax in that year. This may be purchasing an annuity or drawing down a pension as they choose.

CDC

Employers found the CDC concept[4] generally difficult to understand, with EBCs being mixed in their opinions, with some being advocates of the principle and others less convinced that they were a viable option. While there was recognition that theoretically investment pooling could smooth volatility and result in lower charges, there were concerns about how well the idea worked in practice.

Overall, EBCs and some employers also noted that, while DA was not designed to address these, the overarching issues for individuals were not knowing how much they would need to live off in retirement and the inadequacy of contribution levels.

Conclusions

The DA concept was seen as positive. Its implementation raised practical concerns for employers and individuals of efficacy, cost and complexity, but overall consumers were supportive of the idea. EBCs considered there was a need for greater pension flexibility and an appetite in the industry for innovative approaches to smoothing out the risks of fluctuating investment returns. Flexible DB was appreciated in this context, although there was some concern that it may have a limited impact on current DB schemes. This was because the proposals focused on change to the benefits of future accruals rather than the historical challenges and risks faced by employers.

The concept of DC Plus and providing greater certainty through the introduction of guarantees was appealing to individuals and employers. There were concerns about who would pay and the potential impact on investment returns, but overall, consumers were supportive of the concept. Building certainty through buying promises or deferred annuities was also appealing, but EBCs noted the lack of a current market for such products and the complexity of such arrangements for individuals to master.

Some employers found CDCs a difficult concept to understand; EBCs were mixed in their views, with some being advocates while others were not convinced they lived up to expectations.

Defined Ambition

Overall, DA was seen as a positive move towards greater certainty of retirement income. However, the overarching issues of helping individuals to understand how much they would need to live on in retirement and the amount that people are saving for retirement remain.

4 Discussions on CDCs were confined to employers and EBCs. Individuals covered two significant elements of DA in the deliberative discussion groups and it was not possible to include a third concept in the allotted time.

The full report of these research findings is published by the Department for Work and Pensions (ISBN 978 1 910219 14 0. Research Report 866. June 2014).

You can download the full report free from: http://research.dwp.gov.uk/asd/asd5/rrs-index.asp

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