The Challenges of Drawdown
Lessons from the UK?
Joanne Segars, Chief Executive, NAPF
Good morning ladies and gentlemen.

It is a great pleasure and a great honour to address your conference on behalf of the NAPF.

The NAPF is the leading trade association for workplace pensions in the UK.
- Our members include 1300 pension schemes of all shapes and sizes.
- Between them they own nearly £900bn in assets or 1.6tn ZAR.
- They provide pensions for 16m people; and
- pay out benefits of around £80m a day -

Our members also include providers of professional services to those pension funds, including – of course – pension lawyers.

The pleasure in speaking to you is made all the greater by speaking in this beautiful city of Cape Town.

What I’d like to do today is to talk to you about the UK pension system – the good, the bad, and the ugly.

Because workplace pension provision in the UK is at a critical juncture. And it perhaps holds out some important lessons for others in considering pension reform.
The thing that strikes me, whether we are here in the Southern Hemisphere or in the colder Northern Hemisphere, is that the issues we face are the same:

- **How do we provide for our aging population when governments cannot or will not?**

With populations across the globe ageing – and ageing rapidly – this is a pressing issue.

In fact, I’d go as far as saying it is one of the most pressing issues facing society today – though perhaps it is one that often finds its way to the political back burner.

But again, wherever we are, one thing is also clear.

That is, that the choices are limited.
- we can choose to pay more taxes for higher state pensions;
- we can work longer;
- we can save harder...or
- we can accept that we will be poorer in retirement.

Some of these options are clearly unpalatable. Others are politically or economically difficult to achieve or accept.

Of course, in reality, the answer is likely to be a mix of the above: working longer, saving harder, “getting real” about what retirement is likely to mean, and probably paying higher taxes too - not just to pay for pensions, but to meet health and social care needs of an ageing society.

But one other thing is also clear.

North, South, East or West:
• if the state is limited in what it is prepared to pay towards people’s old age, then work-based pensions have an increasing role to play to meet people’s expectations in old age.

That means there will be greater pressure – *even greater pressure* – on workplace pension funds to deliver.

And it also means greater pressure and responsibility on individual fund member to save, understand what they’re saving in, and to understand the risks they’re facing.

These are not trivial issues.

Of course, what’s driving a lot of this is demography.

Let me give you a flavour of what that looks like in the UK.

The number of people aged over 60 will go up by around a quarter between 2012 and 2050, from 14.5m to around 21m. As a proportion of the total population, that means the over 60s will go from around 23% of the population to 30%.

And it’s not just that there will be more older people. The older people will be older.

30 years ago, there were 2,300 people aged over 100. Today, there are around 12,000. But in 30 year’s time, there will be around 150,000. In fact, one-third of babies born in Britain in 2012 can expect to live to 100.

That’s quite astonishing.

And all these people will need supporting financially in old age.
Of course, our ageing pressures are modest compared to those in South Africa.

The UN tells us that the number of people aged over 60 in SA will double between now and 2050, and the old age dependency ratio will fall from 13 people of working age to support each older person to just 7. Of course, you are all familiar with these data. But it does not diminish their significance – or the significance of the change that will bring.

But let me take you back to the UK pension system.

Back in 1997, the then newly-elected Labour Government proclaimed that occupational pension funds were the “welfare success story of the 20th century”. Truth be told, it was a pretty bold claim to make then.

Then there were vast swathes of the workforce who were simply by-passed by the pensions system: women, part-time workers, the self-employed, for example.

But fast forward, and what does the system look like today?
In OECD-speak, ours is a three pillar system.

The first pillar of state pension pays out £110.15 a week [2,000 Rand] – IF you’ve paid enough contributions for enough of your working life, which of course not everyone has.

That system is undergoing reform.

From 2016, a new single tier state pension scheme will be introduced.

Provided you’ve paid a minimum level of contributions – which almost everyone will – you will get the full amount. It will be payable to newly retiring pensioners only. And it will be paid at around £140 a week [around 2,500 Rand].

The effect will, over time, be to reduce reliance on mean-tested top-up benefits. So it is a reform that we at the NAPF have supported.

The third pillar comprises pensions sold on a retail basis, really those outside the ambit of the workplace.

Our topic today, however, is workplace pensions.

Our pension system is a mix of pre-funded DC and DB in the private sector.

Average total contributions to DB schemes are 25%, and to DC 12%.

In total, assets in funded UK pensions top around £2bn [34bn RAND]. Around half of that is in DB schemes.

Other than restrictions on self-investment, there are no restrictions on where, or how, private sector funds can invest.

We use an EET tax system. Though it would be fair to say that the “Es” have been significantly reduced in recent years.

We’ve been told by our Government that we’ve all got to do our bit to pay down the deficit to work our way out of the financial crisis. Our Chancellor tells us “we’re all in it together”. And the Government has turned to pensions to help plug the hole in the nation’s finances.

The Government has limited the amount that can be paid into a pension tax-free each year from April this year to £40,000 [720k Rand]. And the amount that can be saved tax-free in total stands at £1.25 million [22m Rand].
We’ve done quite a bit to address the ageing issue by increasing the state pension age. It will rise from 65 today to 68 by 2046. So one thing is for certain, you certainly won’t be jumping in your VW camper van at 64 to take in the wonders of the Cape Peninsular!

All this change, uncertainty and the small matters of a financial crisis – and some past pensions scandals for those of you with long memories have done little to encourage confidence in pensions.

Twice a year, the NAPF runs a pensions confidence tracker index. In October, the last time we ran the poll, I can tell you that net confidence stood at minus 2. But if I tell you that the previous October the index stood at minus 17 you can see that we’re heading in the right direction.

But the number is still negative, and that’s not good enough. We are just in the process of re-running the poll, and when we next publish the results we will see some more positive news.

The real story that comes out of this for pension funds is the shift from DB to DC as the dominant form of pension provision.

You’re a long way ahead of us as a ‘DC Country’. But the shift in the UK has been rapid.

Today, 88% of private sector DB funds are closed to new joiners. To give you an idea of the speed of their closure, ten years ago around 88% were open. A third of funds are also now closed to future accrual. The pressure on DB funds is enormous. Despite more encouraging economic signals, on average funds are just 92% funded, and liabilities outstrip assets by some margin.

The future is very much DC, therefore.
So if that’s the big story for employers, what’s the big story for individuals? In short, it’s that too few people are saving.

In 2012, less than half the workforce belonged to a workplace pension fund. 12 million people were not saving, or not working enough.

Our voluntary pension system – where employers were free to set up pension funds and employees were free to join them – simply wasn’t working.

So we have embarked on a radical programme of pension reform called auto-enrolment.

Under this system, every worker aged over 22 and earning more than £9,500 a year (173,000 Rand) a year must be put into a pension fund into which employers and employees must contribute.

Once put in the pension fund, people can opt-out. And if they opt out, they’ll be re-enrolled 3 years later.

So it’s soft compulsion. It’s about leveraging behavioral economics and the theory of “nudge”.

Employers must pay 3% of earnings, 4% will come from the employee, and 1% from tax relief. So 8% in total. The contribution level is being gradually phased in over about a 5 year period.

The rules apply to all employers – no matter how small.

To ensure that there are pension schemes available to all employers, especially small employers uneconomic to traditional pension providers, the Government has established a
new pension arrangement called NEST. NEST has a public service obligation to take all employers and charges the equivalent of 0.5% AMC.

Auto-enrolment started in October 2012 with the largest employers having to auto-enroll their employees first, and will work through to the smallest. In total, between 5 and 9 million workers are expected to be auto-enrolled by 2017.

The big unknown was how many people would stay opted in?

Well, it does seem that people are staying put. Opt-out rates far lower than expected – around 10% on average. That’s far lower than the 30% initially predicted.

In fact, as a result of auto-enrolment, over 2 million more people are saving in a pension today than were saving in October 2012.

That’s fantastic news. It starts to turn around a decade of pensions decline.

Most of those employees have been put into DC schemes.

Of course, all of that success has as a result of a huge effort on behalf of employers. It’s been a real case of blood sweat and tears as the rules are extremely complex.

Many of my members tell me that it’s taken a year of preparation. That’s been about getting payroll systems in place, working on member communications, and getting the systems in place.

Despite the huge effort, there remains very strong support for auto-enrolment from employers and funds.

But what’s more important, is that the individuals who have been auto-enrolled seem to like it. Once they’re in a pension scheme, well, they’re getting the pensions savings bug too.

Many saw auto-enrolment as the “boot up the backside” they needed to be saving for old age. In a survey of scheme members, 70% were relieved to be finally saving for a pension.

They were also confident that their employer had chosen a good scheme for them to be auto-enrolled into. So, whilst that reinforces point that where people have confidence pensions, they have confidence in their employer it also reinforces the need for employers to choose a good scheme.

And it reinforces the need to define what good DC looks like. So. So far, so good.
I’ve told you that just over 2 million have already been auto-enrolled. And I’ve told you that 9 million WILL be auto-enrolled. So you can do the maths. That’s 7m more to come.

Those people will be working for small and medium employers who will be new to providing pensions. Frankly, some of those employers will be as clueless about pensions as the employees they’ll be auto-enrolling. So, the hard work is yet to come.

Just look at this chart. You can see the big spikes of employers who will have to auto-enroll this year. In fact, by July this year, 30,000 employers will have to auto-enroll another 2 million workers. That’s double the number so far in half the time.

The problem is that these smaller schemes won’t have the resource or expertise of those that have already auto-enrolled.

So, we will need to make sure:
- they have the support they need;
- they can access advice – and there are some concerns around capacity in the advice market;
- that the legislation is fit for purpose – and even large employers agree it’s too complex; and
- that we can start to engage plan members with top quality communications.

We also have to give employers, funds and their advisers a fighting chance.

I don’t know what it’s like here in South Africa, but in the UK it feels like there’s regulation over load. Ideas for pension reform are coming out of Government at a rate of more than one a month.

It’s difficult to keep your eyes on the big prize if we’re constantly being asked to look elsewhere.
Getting people into pensions is just a part of what we need to do. It’s a big part, turning the country from a nation of pension shirkers into a nation of pension savers. But it is only one part.

Once we’ve got people into schemes, we have to make sure they’re good schemes.

After all, we’re making we’re making them save in a pension. We, collectively – Government, industry, etc – owe it to them to ensure they get a decent deal when they retire. If we don’t, confidence in pensions really will evaporate.

There are 4 issues we now need to turn to to get DC right:

The first is contributions.

Not many of us think that 8% is enough. It is a good start, but a product of political expediency. An 8% contribution will give someone on average earnings a 45% replacement rate. That includes the more generous state pension I talked about earlier.

In other words, it isn’t going to give you a very generous income. 12 or 15% are more commonly seen as being the right kinds of benchmarks.

So there are all kinds of questions about when, how, how fast and who pays more – employers or employees?

So, will need to look at this. And it must be a challenge for the next Government that will be elected next year, not the one after that or the one after that. We will need to start to manage expectations now – and set trajectory. There’s no denying these are difficult discussions. But there’s also no denying that we can’t dodge them.
The second question is about **value for money**.

This is a very live political issue at present, with a focus on scheme charges and value for money. In fact, the Pensions Minister is threatening to impose a charges cap, and the opposition party is egging him on.

The issue is a pretty straightforward one that will be familiar to you. Higher charges mean lower pensions. The OECD suggests that halving management charges can raise pension benefits by as much as 10%.

Costs and charges in the UK *have* fallen. Today, they average around half a percent for new auto-enrolment schemes.

But there are an awful lot of legacy schemes with fund charges far higher than that, sometimes topping 1%. The Office of Fair Trading has undertaken a review of costs and charges and found them to be too high. As a result, there is now a wholesale review of legacy charges.

Of course, we mustn’t just conflate low charges and good VALUE. We wouldn’t want to see a drive for lower charges mean a squeeze on innovative investment solutions that can generate return.

The third question is about **governance**. Rather, it’s about absence of governance in many funds.

First, there’s an issue about making sure that trust-based funds are run by competent people who know what they’re doing.

There’s a concern that many trust-based schemes have grown out of closed DB schemes with the same trustees, under the same trust. So, the risk is that the trustees spend all their time on the DB scheme and squeeze in the DC scheme as an after-thought. Clearly that won’t do.

But then there are those schemes that have no governance arrangements. These are contract-based schemes offered by insurers and the like.

We have argued that there needs to be some kind of governance overlay to ensure that the scheme is being run – and continues to be run – in the interests of fund members.

The final issue is about **scale**.
It’s been clear to the NAPF for some time that DC works best when it’s done in scale. We look to our Australian colleagues and their Super Funds for inspiration here, and also our Dutch friends for inspiration.

The Australians call them Supers. We call them Super Trusts – which is why you’ve got Super Trust Superman on the slide!

Large scale schemes can:

- Provide better governance than smaller schemes. They can have professional executives with professional trust boards. The governance ‘premium’ can be worth an extra 1% of funds under management.
- By leveraging that professionalism and using their superior buying power, they have better access to the market for innovative investment options, better quality advice and administration.
- And, because of their scale and scale efficiencies, they can negotiate lower charges and better value for money.

All of that means bigger pensions for the fund members. And that’s what really counts at the end of the day.

You can see the difference a big scheme can generate on this chart.

A bigger scheme can generate a pension 23% bigger than a small scheme, all things being equal. That’s something not to be sniffed at.

But there’s a long way to go. There are around 43,000 separate DC schemes in the UK. The majority of these are very small. The average DC scheme has just under 3,000 members, and many have just tens of members.

It’s true that some Super Trust-like entities are starting to emerge, like the NEST scheme I
spoke about earlier. Over time, these will take in hundreds of thousands of members – NEST has almost 1m already. But that leaves a big stock of small, poor value and sometimes poorly run schemes still in operation.

That then brings us to the question of what happens at retirement.

In the UK it is compulsory to convert your pension into an income either by buying an annuity or via income drawdown. You can’t just take the money and run. But drawdown requires a big pension pot - £100k [1.7m Rand] plus. The average pension ‘pot’, however, is just around £25,000 [400k Rand].

So annuities are the only game in town for the vast majority.

The problem is, that very many people – the vast majority, in fact – aren’t getting a good deal from annuities. That matters because it is a once-in-a-lifetime purchase.

Research the NAPF commissioned in 2012 showed that £1bn – 17bn Rand – leaks out of the annuities market each year because people get the wrong annuity for their lives or poor value annuity.

For example, people aren’t told they could have an enhanced life annuity, if they’re a smoker for example, which could boost their income by hundreds of pounds.

The graph here shows the difference between the lowest value standard annuity rate and the best value enhanced rate. It’s a significant amount of money.

One way people can help themselves to get the best value annuity is by shopping around. In other words, not taking the annuity from the insurance company they’ve saved with. We call this the Open Market Option, the OMO. And there’s lots of talk about encouraging people to use the OMO.
The trouble is, that for many people – especially those with small pension pots – they can’t shop around. The shop is effectively shut. Providers – and advisers and brokers – simply don’t want to know. The customer is not economic.

It’s not just individual savers who have this problem. It’s true for schemes trying to get best deal for scheme members too. Pension funds tell us that they can’t get access to broking services on decent terms for their fund members because the scheme it too small or the employees too low pensioned.

Our annuities market simply doesn’t work. Pricing policies are at best opaque, and information a-symmetries are huge.

That cannot continue.

We’re not the only group to think that. The regulator for the financial services industry has just completed a year long review of the annuities market.

It concluded that the annuities market is broken. It will now be conducting a much deeper and more powerful market review.

In the meantime, we cannot sit on our hands. So the NAPF is investigating what steps we can take – and what services we can offer our members – to help ensure our fund members and their scheme members get decent.

For example, we are investigating whether we could use our leverage and collective buying power to establish an annuity broking service on special terms.

Lessons from the UK?

So what are the lessons I draw from this, and what are the lessons for you?
Well, first of all, I’m not going to be so arrogant or presumptuous to tell you what you should do, or how you should run your funds.

When I’m not running the NAPF, I chair an organization called PensionsEurope. It’s the EU trade body for NAPF’s across the EU. One thing’s clear from PensionsEurope, and that’s that there’s no “one-size-fits-all” when it comes to designing pension systems, no matter how hard the European Commission try to impose a one-size-fits-all approach to the pension systems of 28 EU Member States.

The system has to fit with the social and labour laws and traditions of the country in which it sits.

Equally, I am sure we’d agree that we can’t think of a single pension system across the globe that’s perfect. We might be able to think of some whose features we like. But perfect – no.

I’ve certainly told you a lot about what’s wrong with the UK’s pension system.

So I think we can learn from each other.

And frankly, I’m eager to learn from you and to find out more about your pension system. After all, you’ve been ‘at’ DC for longer than us.

But I will tell you what does seem to work – in the UK context at least.

Fundamentally, it is that nudge, nudge.

Auto-enrolment really is a game changer. By the time of our General Election next year, 4.3 million people should have been auto-enrolled. That will be an amazing turn around.

I’m struck by how many of my EU colleagues ask me about AE – and how many EU Governments are studying it. Ireland is considering introducing a version of auto-enrolment, for example.

I think the other fundamental has been consensus.

It’s perhaps a bit trite to end on this point, but consensus really does matter when it comes to making pensions policy – at least successful long-term pensions policy. That consensus has existed for over 10 years now. It started with an independent commission to identify the problem and develop the solution, which effectively de-politicised the issue. There was agreement from both sides of the House of Parliament, from the unions and
employers as well as industry groups like ourselves and professional groups like the Association of Pension Lawyers in the UK.

We’ve all compromised along the way. And we disagree around the edges, sometimes quite significantly. But we do all agree on the direction of travel. And that’s important.

So I think there are reasons to be optimistic, and I hope you can see the potential in the UK’s pension reforms.

Joanne Segars
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